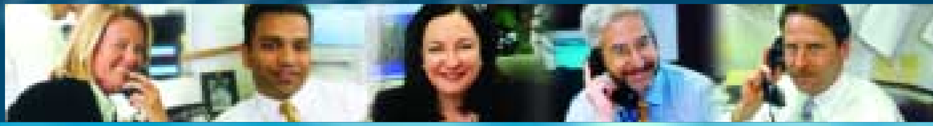
# FIRST ALBANY COMPANIES INC. 2001

Annual Report to Shareholders

FIRST ALBANY COMPANIES INC. 2001 ANNUAL REPORT TO SHAREHOLDERS

## Investment Bankers, Securities Dealers and Investment Advisors



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*Investment Bankers, Securities Dealers and Investment Advisors*

# FIRST ALBANY COMPANIES INC.

First Albany Companies Inc. is a financial services firm offering investment banking, research, trading, asset management and advisory services. Corporate and public clients rely on First Albany's utmost attention to their needs, depth of research, and valuable business relationships in order to achieve financial goals. By concentrating on key growth sectors and underserved market niches and leveraging its team of talented research analysts, First Albany has been able to uncover areas of exceptional value and growth for clients. Founded in 1953, First Albany remains one of the very few institutionally-focused independent investment banks in the country. First Albany is traded on NASDAQ under the symbol FACT and today has 17 offices in 11 states. For our clients, we focus on the following areas:

**Taxable Fixed Income –** Traders of corporate bonds in the secondary market, with a team recognized for its ability to spot value, develop interest in overlooked items, and liquidate challenging blocks of bonds.

**Municipals –** Underwriters and traders of municipal bonds in the new issue and secondary markets, with expertise in transportation, water and sewer, education and health care.

**Equity Capital Markets –** Research-driven investment bankers and traders of equity securities, focusing on the technology, energy and health care sectors.

**FA Technology Ventures –** Venture capital providers for early and expansion stage companies in the emerging growth sectors of information and energy technology.

**First Albany Asset Management –** Investment advisors to institutions and high net worth individuals.

www.firstalbany.com

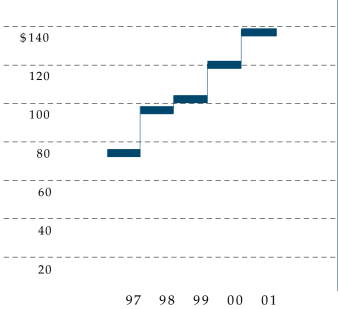
# FINANCIAL HIGHLIGHTS

| *(In thousands of dollars except per share data)* *For the years ended* | *December 31, 2001* | *December 31, 2000* | *December 31, 1999* | *December 31, 1998* | *December 31, 1997* |
|---|---|---|---|---|---|
| **OPERATING RESULTS** | | | | | |
| Net revenues | $ 139,951 | $120,623 | $ 103,997 | $ 99,340 | $ 74,540 |
| Operating revenues | 136,211 | 113,908 | 98,455 | 94,130 | 69,079 |
| **NET INCOME*** | | | | | |
| First Albany Corporation - Investment Bank | $ (1,812) | $ 2,514 | $ (567) | $ 1,598 | $ (1,962) |
| Parent & Affiliates | (118) | (5,447) | (4,293) | 224 | 159 |
| Total continuing operations | (1,930) | (2,933) | (4,860) | 1,822 | (1,803) |
| Extraordinary gain | | | | | 305 |
| Income (loss) from discontinued operations | (1,062) | 422 | 5,273 | 2,516 | 3,454 |
| Gain on sale of discontinued operations | | 22,799 | | | |
| Net income (loss) | $ (2,992) | $ 20,288 | $ 413 | $ 4,338 | $ 1,956 |
| **FINANCIAL CONDITION** | | | | | |
| Total assets | $1,109,084 | $646,125 | $1,008,134 | $842,898 | $831,921 |
| Stockholders' equity | 62,875 | 66,106 | 53,116 | 48,408 | 44,548 |
| **PER COMMON SHARE**** | | | | | |
| Diluted earnings per share* | | | | | |
| Continuing operations | $ (0.23) | $ (0.33) | $ (0.54) | $ 0.19 | $ (0.22) |
| Extraordinary gain | | | | | 0.04 |
| Discontinued operations | (0.13) | 0.05 | 0.59 | 0.26 | 0.41 |
| Gain on sale of discontinued operations | | 2.54 | | | |
| Net income per share | (0.36) | 2.26 | 0.05 | 0.45 | 0.23 |
| Cash dividend | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 |
| Book value | 7.38 | 7.91 | 5.91 | 5.49 | 5.17 |

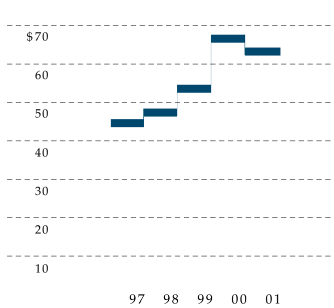
** Due to the sale of the assets of the Private Client Group, the Company's retail brokerage network, to First Union Securities, the operating results of the Private Client Group are reported as discontinued operations on a net income basis.*

*** All per share figures have been restated for all common stock dividends issued.*

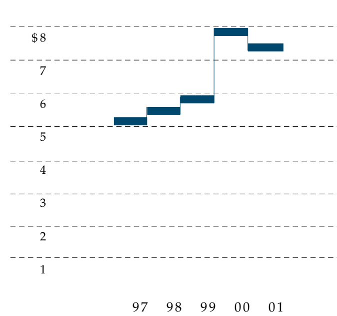
**NET REVENUES**
*(in millions of dollars)*




**STOCKHOLDERS' EQUITY**
*(in millions of dollars)*




**BOOK VALUE PER SHARE**
*(dollars)*



# LETTER TO OUR SHAREHOLDERS

The year 2001 was a challenging year for our industry even before the tragedy of September 11th and the disruption that followed. Our markets were characterized by volatility and increasing illiquidity in both the stock and bond markets. Both markets were shaken by repeated credit collapses. In this challenging environment, fixed income drove our revenues higher.

The outstanding performance was turned in by our taxable fixed income capital markets group. Dealing with tough credits, responding intelligently to market dislocations and matching natural buyers and sellers in otherwise illiquid securities is what we do. In 2001 this group did an outstanding job for their clients and this was reflected in spectacular results — revenues up nearly 90% — contribution up even more.


Alan Goldberg and George McNamee

2001 was a year of steady progress for our public finance and municipal trading group. Public finance continued its industry leading innovation in niche specialties like asset securitization and aviation. Revenues were up strongly in both the tax-exempt and taxable municipal trading, as we work to become more important providers of liquidity and strategy to our institutional clients.

One reason that our markets are growing more illiquid is the massive consolidation that has occurred in our industry. This wave of consolidation has provided opportunities throughout our businesses, but nowhere has the change been more dramatic than in equity capital markets and, in particular, the emerging growth markets — the sector in which we compete. Most of the sector's leading boutiques have been acquired and repositioned by global banking organizations.

Reacting to market conditions and lower volume, we dramatically reduced our head count during the year. Even with these reductions, sharply lower trading and underwriting volume caused us serious losses.

We have made dramatic changes that should lead to profitability in the equity business in 2002. We adopted a new compensation model across the division that rewards production and profitability while reducing our fixed costs. Late in the year we began to recruit aggressively as consolidations made some extraordinarily talented individuals available. With the dynamic new leadership we have recruited to this group, our goal is to build a team of the caliber and competitiveness of our fixed income groups.

In a difficult market environment our asset management group out-performed the indexes and preserved client wealth. Our venture group did well by staying on the sidelines.

We were fortunate that no First Albany employee or direct family member was lost in the tragedy of September 11th. In our Penn Plaza office, we immediately made space available for employees of nine firms that were dislocated. We want to thank everyone who made this work. We especially want to recognize the technology and disaster recovery teams who were able to build out the technology and trading environment to support 165 more people over that extraordinary weekend. This is just one example of the way our industry pulled together to restart the markets after the tragedy.

We are grateful to our shareholders and our clients for their support, and to our colleagues for their commitment to making First Albany a leading independent capital markets and investment banking boutique.

George C. McNamee, *Chairman*

Alan Goldberg, *President*

**FIRST ALBANY COMPANIES INC.**

INVESTMENT BANKERS, SECURITIES DEALERS AND INVESTMENT ADVISORS

Serving the investment and financing needs of corporate and public clients nationwide.

- Taxable Fixed Income
- Municipals
- Equity Capital Markets
- FA Technology Ventures
- First Albany Asset Management

## Taxable Fixed Income

Certainly the volatile markets of 2001 favored our type of business in the Taxable Fixed Income division. Yet market conditions alone cannot lead to the results we achieved. We believe the real roots of our success — and our potential for the future — can be found in our people, who have the ability to focus and execute.

**>> A record year with revenues up 87% and contribution more than doubling**
**>> Continued focus on the secondary corporate bond market**
**>> Differentiated ourselves by finding value in bonds overlooked by others**

Robert F. Campbell

We continue to concentrate our resources and expertise on the secondary bond markets. In doing so, we've gained a reputation with our customers for bringing together natural sellers and buyers — matching the right client to the right product with speed and efficiency. This not only serves the needs of our expanding customer base, it also helps mitigate risks to our own capital. In short, we make our living on client-driven transactions.

With a division of over 65 people, including excellent traders, top-notch research analysts, outstanding sales professionals and a proficient support staff, we are small enough to turn our entire focus towards a fast-developing opportunity. At the same time, we are large enough to scour the market and uncover value that may have gone unnoticed by others.

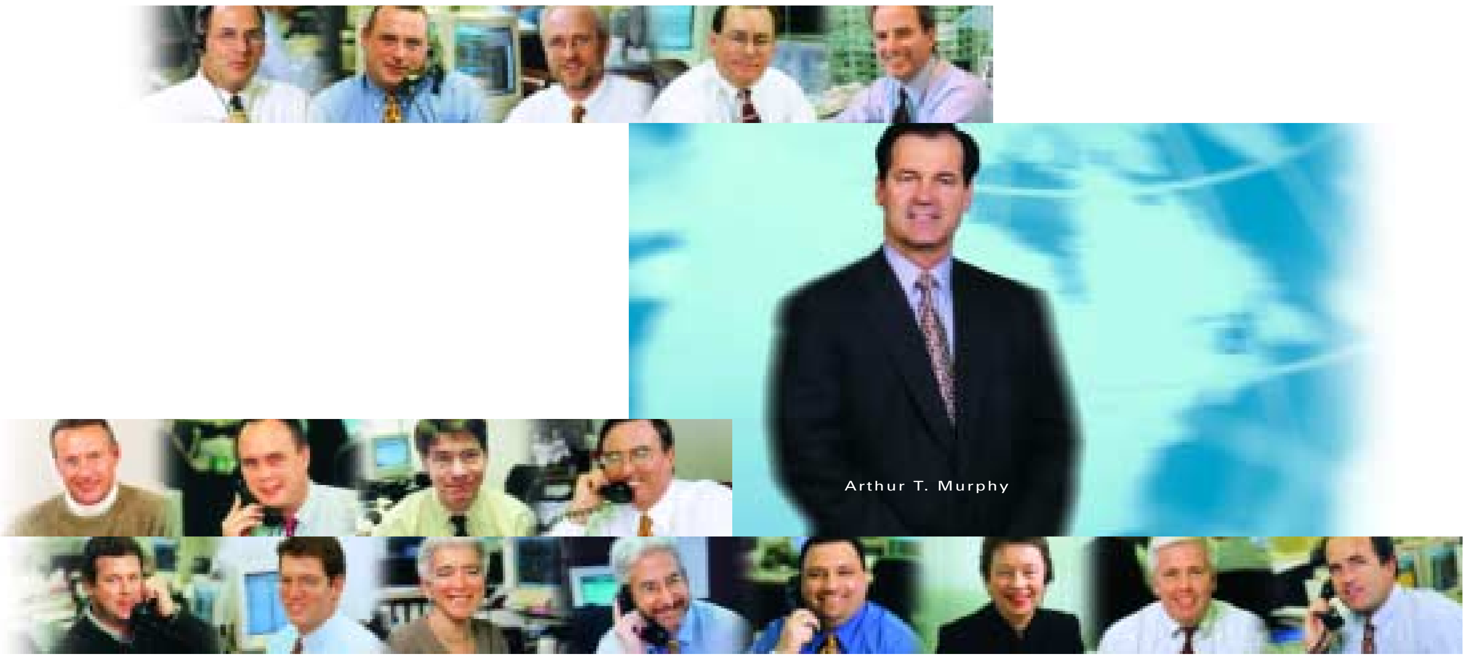
This powerful combination of focus and execution, of customer intimacy and research analysis, has helped us develop expertise in liquidating difficult blocks of bonds. While many competitors are growing larger and more encumbered through consolidation, we have found a sweet spot, both for ourselves and our customers, in overlooked areas of the market.

We believe that continued attention to the strategy that has led to our success thus far, coupled with keeping an eye open for new market opportunities, will lead to strong growth for us in the future.

## Municipals

In 2001, the Municipals Division continued to build First Albany's reputation as an industry leader in underwriting and trading municipal securities. We recorded growth in the education, health care, aviation and tobacco sectors and built market share in the Midwest. We also raised productivity, as measured by increased revenue per employee, in our division of 85 people — a testament to the quality, commitment and experience of our team.

**>> A record year for revenue in new issue underwriting**
**>> 45% rise in secondary market institutional sales and trading**
**>> Reinforced our market leadership in aviation, tobacco securitization and higher education**



Arthur T. Murphy

We are proud of our accomplishments in 2001. We senior managed 56 new issues totaling $1.5 billion and co-managed 117 issues totaling $21 billion — all increases over the previous year and our best year ever in public finance.

We also reinforced our market leadership in aviation, tobacco securitization and higher education. Our aviation business grew and our client relationships deepened, particularly after September 11, when uncertain conditions led airports to rely on our strategic advice and financial services to help maintain liquidity and ratings. We underwrote tobacco settlement deals in Louisiana, Alaska and Iowa. An innovative, senior-managed issue for a 1200-bed housing facility at the State University of New York at Albany was indicative of our work in higher education.

Our trading in secondary volume with institutional clients grew 45% and remains about 60% of our business. Our customers depend on us not just for transactions, but for our ability to research and create solutions that help them meet portfolio goals and solve problems. This customer-focused capability enables us to compete against larger firms, as does our niche expertise in taxable municipals and high-yield municipal bonds.

In 2002, we plan to grow all aspects of our business. It is apparent to our customers and others in the industry that we are in the municipal business for the long haul — at a time when other firms are leaving it behind due to industry consolidation and strategy shifts. This industry environment, combined with our own vision, people and expertise, will help us continue to perform and maintain leadership in this industry.

## Equity Capital Markets

The Equity Capital Markets division is a sector-focused and research-driven investment banking boutique. Our corporate and institutional clients depend on us for research, trading, capital raising and advisory services. They also depend on us to understand their needs and provide sector expertise — personalized services they may not be able to get from larger, commodity-focused investment banking conglomerates.

**>> Managed expenses aggressively in a very challenging equities market**
**>> Added experienced and talented personnel throughout the division**
**>> Improved our focus in areas of emerging growth where we can add significant value**

Robert Gales and Timothy R. Welles

Our industry is in the midst of significant change. Capital raising and merger & acquisition activities have declined, and positive investment returns are significantly more difficult to achieve than in the recent past. In addition, consolidation and downsizing continue as firms attempt to deal with the difficult market environment. From this environment, we believe the next truly successful boutique firms will emerge, and we are moving aggressively to fill the void created by consolidation and the trend toward a more commodity approach to client service. Our reputation for high quality, individualized service to our clients, coupled with market conditions, enabled us to recruit some of the brightest industry minds — passionate and motivated professionals like us who want to make a direct and positive impact on clients.

As a result of changes we have made, we are leaner and more nimble than a year ago, and we are stronger and more focused. We have built up our practices in health care and energy, putting them on par with our established and well-regarded information technology practice. And we uphold our vision that the emerging growth areas of health care, information technology and energy technology continue to hold promise for strong investment opportunities in the coming years.

Our exclusive relationship with META Group Inc. allows us to provide proprietary research on trends throughout the information technology sector. This information offers us an unique and important customer perspective on the companies we study in this market sector. In turn, we can use this perspective to make better recommendations for our own clients.

As we begin 2002, our people are poised to take advantage of new market opportunities. We will continue to provide a mix of investment banking and trading services, working to manage risk while achieving a positive return for our division, and for our clients.

## FA Technology Ventures

Gregory A. Hulecki, George C. McNamee and Kenneth A. Mabbs

From beginning to end in 2001, caution dominated the venture capital market and private valuations slid. Yet these conditions opened the door for FA Technology Ventures to complete our first investment and commit to a second. Now, with valuations showing signs of stabilizing, we plan to accelerate our rate of investment in 2002.

### highlights

- >> First complete year of venture fund operation in 2001
- >> Focus on early and expansion stage Information and Energy Technology companies
- >> Made first venture investment in a new company, committed to a second

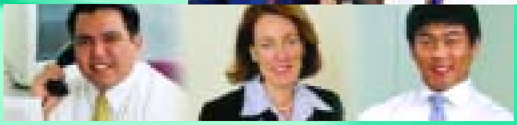
We believe the realization and endurance of a new economy depends on the existence of pervasive communications and energy networks. It depends on venture capital investments in new and innovative companies that have the vision to make these networks an everyday reality. The investments we have and will make, reflect our commitment to this view.

During 2001, we completed an investment in IP MobileNet, a provider of private wireless voice and data networks for the public safety, utility and transportation sectors. We also committed to (and subsequently funded in early 2002) an investment in Seranoa Networks, an early stage data communications company offering switch technology to increase traffic capacity at the edge of networks where most communication bottlenecks occur.

Our investments will help these companies accelerate the path to profitability, fuel product development and expand in the market place. At the same time, these investments were carefully researched and selected with an eye towards generating a superior rate of return to First Albany and our other investors.

We have in place an exceptional investment management team, outstanding information resources from First Albany's corporate finance and research groups and the META Group, and over $100 million in our venture capital fund. In the coming year, we see business prospects continuing to improve, and are poised to invest more aggressively – and no less wisely.

FA Technology Ventures acts as the advisor
to FA Technology Ventures L.P.



## First Albany Asset Management

We had a solid year in the First Albany Asset Management division providing investment advice and asset management services. We brought in new assets and retained our existing client base. This is especially rewarding given that difficult markets such as we experienced in 2001 typically lead to high client turnover. We attribute much of our success to our ability to anticipate and respond to client needs, and our disciplined approach to portfolio management.

**>> Brought in new assets and retained existing client base**
**>> Continued to capitalize on our proprietary methodology for portfolio management**
**>> Now manage over $640 million in corporate, institutional and individual assets**


Hugh A. Johnson

Our team of 15 professionals works hard to know each of our clients — their investment objectives, risk tolerance, liquidity needs, and tax situation. We combine this knowledge with our proprietary methodology for portfolio management: (1) identifying trends in the financial markets, (2) confirming those trends against our extensive economic research, and (3) positioning portfolios to participate in those trends.

This methodology is the foundation for our Core Investment portfolio focused on identifying the best performing companies in the ten principle market sectors. To complement this portfolio, and to serve clients with different investment styles, we also offer a Value Investment portfolio.

The value approach seeks out companies trading below their potential and undergoing managerial or strategic changes that can lead to higher stock price. For both portfolios, we strive to manage risk and generate an above average return for clients under changing market conditions.

In 2001 we became AIMR compliant, which is the industry standard for reporting investment performance results, and a route to more industry contacts and potential clients. As a result, new distribution networks will be open to us, providing an additional source of national exposure.

We are optimistic about the coming year. We anticipate more investors will return to the market, although more cautiously and slowly than in the past. When they do, we will be there for them, eager to get to know their needs and to deliver the kind of results our clients have come to expect.

## THE YEAR AHEAD

*by Hugh A. Johnson, Jr.*

The truth is that, in 2001, forecasters were right about the shape of the outcome for the equity markets and the economy, but were wrong on the timing. Most had forecast that the bear market would end in the first or second quarters and the soft-landing would end and an economic recovery would begin in the third quarter. As it turned out, both the bear market and the recession had stronger legs. The bear market lasted until September and the start of a recovery in the economy and earnings was postponed until the fourth quarter.

There are good reasons to argue that the U.S. economy, which appears to be recovering, may have yet another sinking spell. This has become known as the dreaded W or "Double-Dip." The argument for this second dip lies in an interesting historical correlation between the duration and magnitude of bear markets and the accompanying recessions. Since the 2000-2001 bear market was the third longest and second most severe of the postwar period, it's hard to believe that the recession will be shorter and shallower than average. Yet it now looks as though the 2001 recession will go down as the mildest of the postwar period. Intuitively that's troubling. If there were another sinking spell that makes the current cycle conform to historical patterns, the stock market would likely suffer another setback. This may be the biggest risk that we face in 2002.

**... All of the conditions that ordinarily accompany the end of a recession and beginning of a recovery are solidly in place.**

On the other hand, there are reasons — good reasons — to dismiss forecasts of the dreaded W or "Double-Dip."

1. All of the conditions that ordinarily accompany the end of a recession and beginning of a recovery are solidly in place. The Federal Reserve has eased aggressively, domestic liquidity conditions are very positive, and leading economic indicators are rising.

2. Responding to the conditions stated above, the financial markets have been signaling clearly that a recovery in the economy and earnings is coming. Since September 21st, the stock market has risen and investors have migrated to sectors of the stock market that traditionally have been the leaders in the first stage of a bull market. Technology, consumer cyclical, industrial, basic material stocks have been the 4 best performing sectors. Moreover, investors have migrated away from those sectors that have traditionally performed poorly in the first stage of a bull market. Healthcare and consumer staples stocks have been the 2 worst performing sectors. In addition, interest rates have edged higher, the yield curve has steepened, and quality spreads have narrowed.

3. As bear markets and recessions have gone, historically; this one has been about as long as they ordinarily last if not longer. The average duration of bear markets and accompanying recessions in the postwar period have been 15 months and 12 months, respectively. At 18 and 9 months, the current bear market was, if anything, long and the current recession just below average.

The strongest case is that the bear market ended on September 21st and a recovery in the economy and earnings will continue…uninterrupted.

## The Economic Forecast

We can, as always, quantify our view of what lies ahead. Ordinarily the way we do this is to (1) accept the current consensus forecast for the economy and consumer inflation and (2) measure statistically the implications of that forecast for inflation expectations, Federal Reserve policy, and short-term interest rates. Then, on the basis of a forecast for inflation expectations and short-term interest rates, we can forecast long-term interest rates. On the basis of a forecast for the economy we can forecast corporate profits and S&P 500 earnings. And on the basis of a forecast for long-term interest rates we can forecast price/earnings ratios. What we look for is a forecast that is internally consistent as well as consistent with financial market history as we know it.

**CONSENSUS FORECAST**

| YEAR 2002 | *Gross Domestic Product (BN96$)* | *Annual Rate* | *Consumer Price Index* |
|---|---|---|---|
| 1st Quarter | $9,402.3 | 2.6% | 1.2% |
| 2nd Quarter | $9,476.8 | 3.2% | 0.8% |
| 3rd Quarter | $9,562.2 | 3.6% | 1.2% |
| 4th Quarter | $9,650.2 | 3.7% | 1.9% |

*Quarterly numbers are estimates.*

*Source:* BLUE CHIP ECONOMIC INDICATORS

As the reader can see (chart at right), the consensus expects the economy to recover without interruption. That's very good news for equity investors. Moreover, if we dig down and look at the details of the recovery, there are some additional important factors. Consumer spending is likely to be restrained (2.5%); business spending in general and spending on technology is likely to begin to recover in the second half; housing is likely to be quite flat; and government spending, particularly spending on security and defense, is likely to be strong.

If the consensus is right on the economy, then short-term and long-term interest rates are likely to rise. Implicit in this forecast for short-term interest rates is a forecast that the Federal Reserve will raise its target for the federal funds rate from 1.75% to 2% in July and continue to raise short-term interest rates in small steps in the third and fourth quarters.

Although the business recession has been extraordinarily mild by postwar standards, the profits recession has been extraordinarily severe. Whereas the business recession has been the least severe, the profits recession, at -29%, has been the 2nd most severe. If the economy recovers as expected, the profits recession will come to an end. We anticipate profits will again be growing on a year-to-year basis by the third quarter. By the 4th quarter, the growth rate of both corporate profits and S&P 500 earnings should be double-digit.

If we are right on the economy and profits and interest rates, then, while earnings for the S&P 500 should rise, price/earnings ratios should remain little changed before beginning to decline. We anticipate that the "good news" of improving earnings will more than offset the "bad news" of rising interest rates and declining price/earnings ratios. That's the way bull markets that are not financial bubbles ordinarily play out. It also explains why bull markets ordinarily provide returns of 10% to 12% and not 20%+ as was the case between 1995 and 2000. Here's a forecast.

**EARNINGS FORECAST**

| YEAR 2002 | *S&P 500 Earnings (qtr)* | *S&P 500 Earnings (ltm)* | *Price-to-Earnings* | *S&P 500* |
|---|---|---|---|---|
| 1st Quarter | $10.37 | $42.53 | 26.5 | 1129 |
| 2nd Quarter | $10.53 | $41.83 | 27.4 | 1148 |
| 3rd Quarter | $11.07 | $42.36 | 27.8 | 1178 |
| 4th Quarter | $11.99 | $43.96 | 27.6 | 1214 |

*Quarterly numbers are estimates.*

*Source:* BLOOMBERG NEWS, FIRST ALBANY

As always, there are substantial risks.

Our view is that there is a risk incubating. That risk is that monetary policy has been, in our view, extraordinarily aggressive.

This may have been a mistake. Growth rates of reserves and money have been nearly unprecedented. Perhaps they needed to be since we have, as a country, faced dire challenges in 2001. Even so, it is important to understand that, as always, there are no solutions; only tradeoffs. If the economy begins to recover, inflation expectations may rise far more rapidly than has been the experience of the decade of the 1990s. If that occurs, the Federal Reserve may need to be as aggressive raising short-term interest rates as they were in lowering them.

The second risk will be, as always, valuation. Bull markets are never “wrinkle-free.” They move from being under-valued to being over-valued. This is quite likely to be the case throughout 2002. Although the move up in stock prices that we summarized above is not particularly encouraging, if investors are reasonably good at timing, they will be able to post returns.

**... Investors who are sensible; who exercise patience and have sound long-term perspective, will again be rewarded.**

Political risks will be very high in 2002. There is a strong chance that the next move in the War on Terrorism will be against Iraq. That alone does not, in our view, threaten the interruption of oil flows from the Middle East to other parts of the world. Hence, we do not believe it would significantly disrupt or even derail the recovery. If, however, the conflict were to spread and involve either Iran or Saudi Arabia, the risks would become very substantial.

For the last four years we have been chronicling the anatomy of the biggest financial mania of the last 100 years. Like all manias, it ushered in extraordinary excess. Not only did technology and Internet stock prices rise to irrational levels driven by widespread euphoria and ubiquitous financial blind spots, but it also left us with significant excess capacity in nearly everything from routers to communications switches to fiber-optic cable. In fact, 95% of the fiber-optic cable laid in the last few years is unused. We now have, we believe, successfully managed our way through the mania. The excess capacity ushered in by the excessive spending on technology products is being eliminated; the period of stock market revulsion that inevitably accompanies the speculation and financial distress of a mania is behind us. Internet stocks collectively have declined 90% from their highs.

Although this has been painful, it has also been healthy. The financial markets are now returning to normal patterns. Although the returns that will be available will certainly pale in comparison to those available during the mania, they nevertheless will be sound. Investors who are sensible; who exercise patience and have sound long-term perspective, will again be rewarded.

As was the case last year, there will be events along the way in 2002 that will require us to change the asset allocation, sector allocation, and capitalization allocation of a portfolio. These events cannot be anticipated. To a large extent, good performance will depend heavily on being able to understand the implications for the markets of exogenous events and to change a portfolio to reflect that understanding. We’ll try our best to do that. As always, doing so successfully will depend on having learned the lessons of financial market history well, but also understanding the differences.

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