UNIT 11 INVESTMENT BANKING

Structure

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11.0 OBJECTIVES

After studying the Unit, you should be able to:

- define investment banking;
- explain how the investment banking process helps in the capital acquisition process;
- describe the process of, and steps in, an Initial Public Offering; and
- discuss the issues of possible over-subscription and under-pricing of IPOs.

11.1 INTRODUCTION

In Unit 9, you studied the function of financial intermediation. In that Unit, you were acquainted with the working of financial intermediaries. Sometimes a distinction is made between financial intermediation on the one hand, and direct financing through financial markets. In this suggested dichotomy, the exchange of funds between savers and investors is accomplished either by a direct exchange of credit between borrowers and lenders or by an indirect exchange through a financial institution. This dichotomy can be misleading because those organisations and firms issuing securities (raising capital) almost invariably make use of the services of financial intermediaries like investment banks, merchant banks, and brokers. We study precisely this function of investment banking in this Unit: how they help in the capital acquisition process for those who need these, and how they perform underwriting operations, how optimal underwriting contracts are arrived at.

In this Unit we look at the nature of investment banking and the role they play in capital markets. Investment banking firms (for these banks are firms) perform a critical role in the primary as well as secondary markets for securities. Investment banking firms perform two important functions. First investment banks helps companies that need funds to raise these funds. Secondly, for investors who need to invest funds, investment banks act as brokers or dealers in the buying or selling of securities.

Our objective in this Unit is to see how investment banks act as financial intermediaries. We will see in the next section how investment banking aids in the capital accumulation process. In the following two sections, the Unit discusses public offerings – mainly in the primary market, and costs that are associated with these offerings. The final section of the main body of the unit discusses the consequences of the over-subscription and/or the under-pricing of IPOs.

11.2 INVESTMENT BANKING AND THE CAPITAL ACQUISITION PROCESS

What are the principal functions of an investment bank? Why is it called an 'investment' bank? How does it help in the capital acquisition process of firms? These are questions we explore in this Section. Investment banks perform two main functions for their clients. These are: raising funds for their clients, and helping clients in the sale or purchase of securities. In this Section we discuss the basic functions of investment firms and the basics of underwriting processes. But first we take a look at the main broad functions of investment banks. Some have suggested that invested banking can be defined in terms of the types of function they perform. Hence four types of definitions of investment banks have been suggested.

According to the broadest definition investment banking includes all functions related to the securities markets as well as other financial services like real estate and insurance. The next broadest definition considers all types of activities related to capital markets, from underwriting and corporate finance, to mergers and acquisitions to venture capital. In this definition certain other financial functions are excluded that are included as per the first definition. This second definition would exclude activities like real estate, insurance, and mortgage banking. The third definition is narrower than the first two. In this definition, only some activities of capital markets are included. The stress is on underwriting, and on their role in mergers and acquisitions. Venture capital, primary commodities trade etc are excluded. The final definition is the narrowest of the four and is closest to the traditional historical definition of investment banking. This fourth definition restricts the functions to those of underwriting and acquisition of capital in the primary markets, and brokering and helping in the deals in the secondary market. In this Unit, we primarily restrict ourselves to this final definition.

We will deal with securities markets in the next Unit. Here we discuss the process of underwriting of securities by investment banks, as that is their main function. An underwriter firm (investment bank) is a firm that buys an issue from a company and resells it to investors in the primary security market; it is thus a primary market activity. Underwriters buy the securities to be issued at a reduced (discounted) price. This discount is usually measured as a percent of the price of the issue. A firm that wants to raise capital can do so primarily through debt instruments (borrowings) or by issuing equity shares in the primary market. Most primary issues of securities are sold by the firm to the public through investment bankers. Investment banking firms are broker-dealer firms that provide a number of services, depending on the type of offering. Investment banks offer services both to the issuing firm and to the investing public. In a usual offering to the public in the primary markets, investment banking firms provide three services: (1) the advisory or managing function (2) the underwriting, or risk-bearing function and (3) the selling, or distribution, function.

In an underwriting process that is of the negotiated variety, the managing underwriter is involved with the public offering right from the beginning, that is, from the time that the issuing firm decides to raise new capital. The managing and advisory underwriting investment bank advises the firm that is engaged in the process of capital acquisition as to the types of securities that the primary market would be most receptive to, when to actually carry out the issuing of the securities, and most importantly, how to price the security, that is, the price at which the security ought to be offered. The investment bank also tries to ensure that all legal requirements connected to the issue are met.

The other main function of the managing underwriter investment bank is the formation of an underwriting syndicate. The members of this syndicate buy the securities from the issuing firm on the day of the offering in the market. Thus the issuing firm is assured of receiving the proceeds of the issue regardless of whether investing public will eventually buy the securities. This is how investment banks help in the capital acquisition process by firms by giving an assurance that their primary offer will be bought (by them). After buying the securities from the firm, the investment bank (the underwriter) is the owner of the securities till the time it sells the securities to the public. Thus the investment bank becomes the bearer of the risk that the securities are correctly priced. Usually the investment bank engages in pre-selling activities in the form of talking and communicating with the public to get an idea of whether the public will accept the securities and at what price. They thus have a very good idea of the correct price of the securities. When the securities are finally sold to the public these are sold by the underwriting syndicate, or there might be involved members of selling groups. These members of selling groups are broker-dealer firms that buy the securities from the underwriters and in turn resell the securities to their customers. Investment banks provide a solution to the information asymmetry about the issue of a firm by analyzing the issue and the firm in detail. By pricing the issue fairly, they gain "reputation" capital, which is important for their future deals and for their prestige.

If we extend the functions and thus the definition and ambit of investment banking we could include their activities in mergers and acquisitions (M&A) of one firm by another. Leveraged buyouts are also included in mergers and acquisitions. Also included in M&A are restructuring of recapitalisation of companies, and reorganisation of bankrupt firms. Investment banks may participate in M&A activities in one of several ways. They can identify and find companies that could be acquired or merged with. Secondly, investment banks could advice the acquiring or the target company on the various terms of the acquisition or merger, including the price. Finally, investment banks help the acquiring firm to find funds for the purchase of the target company. The investment banks receives many kinds of fees for activities performed like an advisory fee or a percentage share of the selling price.

Sometimes an investment bank commits its own funds by either taking an interest in equity or acting as a creditor in companies. In these situations the investment bank is known as a merchant bank.

Check Your Progress 1

1) What are two main functions that investment banks perform?

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2) Give the broadest definition of investment banks in terms of function.

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3) What is a merchant bank?

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11.3 INITIAL PUBLIC OFFERING

Initial Public Offerings (IPOs) are the first time a company sells its stock to the public. Information regarding a public offering is available in the *prospectus*. The prospectus is a document that by law has to be furnished to each investor. When a company decides to issue a new security, it can sell it as a public issue or private issue. There are two types of public issues: the general cash offer, where equity issue is sold to all interested investors; and the rights offer which is an offer that gives a current shareholder the opportunity to maintain a proportionate interest in the company before the shares are offered to the public. All IPOs are cash offers because if the firm's existing shareholders wanted to buy the shares, the firm would not need to sell them publicly. The securities involved in a public offering can be classified into two groups, known as the seasoned and unseasoned securities. The seasoned securities are those that are more of a type already in the market. For example suppose Infosys has shares already in the market. It later makes a public offering in the primary market of many shares because it has a need for capital. These additional shares offered would be seasoned securities. In contrast to seasoned shares, unseasoned securities are those that are being offered to the public for the first time. These are the initial public offerings. There is no established price for them. The offer price is negotiated between the issuing firm and investment bank.

Sometimes IPOs are associated with huge first-day gains; at other times, when the market is not receptive, they fail. It is often difficult for an individual investor to realise the huge gains, since in most cases only institutional investors have access to the stock at the offering price. By the time the general public can buy and sell the stock, most of its first-day gains have already been made. However, an informed investor should still watch the IPO market, because this is the first opportunity to buy these stocks.

When a privately held corporation needs to raise additional capital, it can either take on debt or sell partial ownership. If the corporation chooses to sell ownership to the public, it engages in an IPO. Corporations choose to "go public" instead of issuing debt securities for several reasons. The most common reason is that capital raised through an IPO does not have to be repaid, whereas debt securities such as bonds must be repaid with interest.

The aftermarket performance of an IPO is how the stock price behaves after the day of its offering on the secondary market (such as the NSE or the BSE). Investors can use this information to judge the likelihood that an IPO in a specific industry or from a specific lead underwriter will perform well in the days (or months) following its offering. The first-day gains of some IPOs have made investors all too aware of the money to be had in IPO investing. Unfortunately, for the small individual investor, realising those much-publicized gains is nearly impossible. The basic problem is that individual investors are just too small to get in on the IPO market before the jump. Those large first-day returns are made over the offering price of the stock, at which only large, institutional investors can buy in. The system is one of reciprocal assistance, in which the underwriters offer the shares first to the clients who have brought them the most business recently. By the time the average investor gets an attractive IPO, it's on the secondary market, and the stock's price has already gone up.

Sometimes firms cannot raise funds in the primary equity markets with the aid of investment banks. They need to find other ways of raising capital. A company short on capital might explore the possibility of bank or other financial institution financing, a possible joint venture with another company or a sale of some of the assets of the company as other methods of finding ready capital. Another important alternative is a private placement of securities, either to angel investors or, in appropriate circumstances, venture capitalists. Venture capital generally refers to the outside capital invested to finance a new and growing business. Since most firms are not big enough, successful enough and old enough to raise capital in public equity markets, they need to raise capital in the private equity market. Venture capital is part of the private equity market. Venture capital is generally invested in enterprises that are too risky for public capital markets or bank loans. The biggest advantage of the private placement over the IPO is cost – the cost of completing the IPO and the cost associated with periodic disclosure and reporting obligations following the IPO. At just a fraction of the cost of an IPO, but typically at much lower multiples, a private placement may be possible. It is also easier for the management of a company to control a small group of qualified and well-informed private investors than to deal with the public every time a critical decision involving the company needs to be made.

Check Your Progress 2

1) Distinguish between seasoned and unseasoned securities.

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2) When firms find it difficult to raise capital through IPOs, what are other alternative ways of raising capital?

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3) What is the possible advantage that private placement has over IPO?

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11.4 THE COSTS OF PUBLIC OFFERING

We have discussed the process of going in for IPOs. While IPOs are important ways for firms to raise capital, there are not always features of IPOs. There are some drawbacks to an IPO, too. A large drawback of going public is that the current owners of the corporation hitherto privately held lose a part of their ownership. Corporations weigh the costs and benefits of an IPO carefully before deciding on an IPO. The most obvious cost of having an IPO is the *expense*. It costs money to raise capital. The legal fees, printing costs, and accounting fees associated with registering an IPO can run into a huge amount of money. On top of those costs, the rules for making a company into a public one are so complex that most companies have to hire experts to handle all the paperwork. As far as shareholders are concerned, they themselves constitute another drawback for the issuing firm of going public. The original primary owners are no longer in a private company that can make independent decisions. The investors who purchased stocks at the IPO own a certain percentage of the business, and their demands cannot be ignored, even if they don't have a controlling interest (more than 50% of the shares) in the company. The company's new owners will expect a certain return on their investment, subjecting the management of the firm to tremendous performance pressures. Substantial time and effort, and thus money, must be expended in dealing with the investing community in order to ensure that investors and analysts remain satisfied with the company's performance over the short term, while at all times keeping in mind, and working towards, management's long term goals for the company. Shareholders also want to see the value of their stocks rise, so if the stock price drops or remains stagnant, the company will have to deal with unhappy owners, who are, of course, part owners. If they become unhappy enough, they may sell their stocks, which will cause the value to drop further, decreasing the overall value of the company. Another drawback for a company making public offerings is that offerings have certain legal aspects that must be followed. Public companies are also open to public scrutiny. Annual financial reports, internal transactions, and balance sheets are all open to inspection. This is more of a problem for some companies than others, particularly companies who might have made deals that are not legal or have altered or tampered with financial reports.

An IPO is not without its disadvantages. The biggest consideration for many companies is the substantial out-of-pocket expense that is involved in preparing an IPO for market. As compensation, the underwriter who agrees to take on the IPO in a firm commitment offering purchases the stock to be offered to the public at a discount from the public offering price, sometimes as much as 9% or more but more typically 6 or 7%, depending on the size of the offering and the risks the underwriter might face in bringing a company to the market. Lawyers, accountants, and financial analysts will also command significant cash outlays months before an IPO even hits the market.

Undertaking an IPO is a business decision that must be based on consideration of a number of factors that indicate whether an IPO is an effective use of the company's— and its management's— time and resources. Balancing key characteristics of a company, such as size, stability, product lines, markets, and management, determines whether an IPO is advisable and, ultimately, whether it will be successful. Investors often look for companies whose debt-to-equity, liquidity, and debt coverage ratios meet or exceed industry averages. In addition, investors generally look more favorably upon an IPO, the proceeds of which are to be used for long-term growth and expansion, rather than to pay off debt, or fund a return of investment to certain insiders.

11.5 OVER-SUBSCRIPTION AND UNDER-PRICING OF IPOs

Initial public offerings are generally underpriced. Since the underwriters want to have the offering sell out quickly, they have an incentive to underprice the new securities. At the price offered there is excess demand, that is, demand usually exceeds the supply. Issues, in other words, are oversubscribed. Instead of prices being raised to the equilibrium level, there is extensive rationing. Typically, at the offer price there is excess demand, and shares are rationed to investors. All investors, both informed and uninformed are rationed. The observed rationing of informed investors runs counter to our intuition for two reasons. First, it contradicts the optimal IPO mechanism that postulates that, amongst informed bidders, those with higher signals receive their full allocation before any shares are given to bidders with lower signals. Second, it seems to contradict profit-maximization on the part of the seller. There is little evidence about who benefits from IPO underpricing and why. Do institutions receive larger allocations than individual investors? Do institutions concentrate on the most underpriced offerings because they are better informed than individual investors or because underwriters use their superior knowledge to intentionally favour their long-term clients? If, on the other hand, allocations to institutional investors are unrelated to first day returns, is it because institutions lack superior ability or because allocations of coveted underpriced shares carry the obligation of participating in overpriced issues? There have been reports of scandals in the allocation of heavily underpriced offerings.

IPO underpricing arises as a consequence of asymmetric information and rationing. The value of the new shares offered is uncertain. A group of investors, the informed, have perfect knowledge about the realized value of the offering. All other investors, including the issuing firm and the underwriter, are uninformed; they can only form an expectation about the distribution of the issue's value. In this setting, new shares cannot be priced at their expected value. Informed investors crowd out the uninformed when the offering price is set below its true value; similarly, the informed withdraw from the market when the issue is overpriced. Uninformed investors are not allocated any underpriced issues given the rationing imposed by informed demand, but receive all the overpriced offerings. The uninformed then abstain from participating in the new issues market unless the issuing firm prices the shares at a discount.

Check Your Progress 3

1) What are the main drawbacks of offering IPOs?

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2) Explain why IPOs are usually underpriced.

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3) Why is the observed rationing of IPOs counterintuitive?

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11.6 LET US SUM UP

In this Unit, we have taken an analytical look at the nature and process of investment banks. We saw that investment banks perform extremely useful functions in the financial system and aids in the capital acquisition process. Investment banks make it easy for firms that wish to raise capital through equities to do that. We began by looking at the concept of an investment bank. The primary and narrow definition we worked with was in terms of investment banks' tasks of underwriting. We however looked at some progressively broader definition of investment banking. We went on to discuss the role of investment banks in the capital acquisition process by firms.

We elaborated the processes related to IPOs. The Unit then went to look at the costs of IPOs, which, other than the involved expenses, also stemmed from the fact that the original owners were relinquishing part ownership. We finally dealt with the important issue of there is a tendency for IPOs to be underpriced, and why there is oversubscription of equities, that is, some kind of rationing in the sense that excess demand is allowed without the price being raised.

11.7 KEY WORDS

Initial Public Offering : The selling of securities to the public in the primary market.

Investment Bank : A bank that administers, promotes, and distributes new securities.

Oversubscription : A situation when the number or the total value of the security for which the investors have applied is more than the number or the total value of the security issued by the company

Under-Pricing of a Security : When the buyer or investor is not willing to pay the price for the security that would be warranted as per its earnings per share or price-earnings ratio.

Underwriter : These are firm that buys an issue from a company and resells it to investors

11.8 SOME USEFUL BOOKS

Bhole, L.M., (2004), *Financial Institutions and Markets*, 4th edition, Tata-McGraw-Hill, New Delhi.

Johnson, H.J., (1993) *Financial Institutions and Markets*, McGraw-Hill, New York.

Neave, Edwin, (1998) *Financial Systems: Principles and Organisation*, Routledge, London.

11.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See Section 11.2 and answer.
2) See Section 11.2 and answer.
3) See Section 11.2 and answer.

Check Your Progress 2

1) See Section 11.3 and answer.
2) See Section 11.3 and answer.
3) See Section 11.3 and answer.

Check Your Progress 3

1) See Section 11.4 and answer.
2) See Section 11.5 and answer.
3) See Section 11.5 and answer.