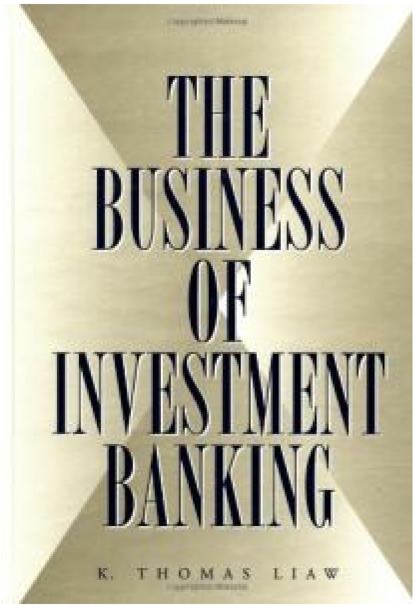

Book The Business of Investment Banking

K. Thomas Liaw
Wiley, 1999

Recommendation

What exactly do the Masters of the Universe do between weekends at their Hamptons estates? While most of us have a vague idea of what investment banking is, businesspeople need a clear understanding of what goes on behind the Wall Street curtain. This book pulls that curtain aside with a systematic explanation of the businesses, strategies and tools of the major investment banks. Parental advisory: The book features a technically complex subject being addressed by a professor in finance. Some colorful anecdotes or engaging examples might have lightened the mood, but this isn't exactly Oprah territory here, and *BooksInShort* heartily recommends this solid book. Writing with expertise, Thomas Liaw breaks down the current business of investment banking and examines the changes that are blending the profession with commercial banking and insurance, a process that could reduce the Masters to mere mortal servants of global financial services supermarkets.

Take-Aways

- Legislation has blurred the lines between commercial and investment banking.
- Demand for one-source financial services has given rise to multiple-service firms.
- Investment banking is moving toward one-stop shopping and globalization.
- The trend toward one-stop shopping eventually will merge banking, insurance, securities and fund management into one integrated industry.
- Investment banking's scope now includes underwriting, private placement, mergers and acquisitions, and much more.
- The investment banking community derives tremendous income from M&A – a bank may get only 1% of the transactions, but the deals are gargantuan.
- Going public can cost 10% of the funds raised, mostly going to investment banks.
- Most investment banks now run venture-capital arms, which manage funds, sell companies and take companies public.
- Investment bankers revolutionized finance with asset securitization.
- Investment banks are rushing into money management, which provides a steady revenue stream that helps offset the volatility of their other businesses.

Summary

Render Unto Caesar...

The first private equity investor may have been one Marcus Licinius Crassus, a Roman in the time of Julius Caesar. When a dwelling caught fire, Crassus dispatched his agents and firefighters. If they believed the building was worth saving, they offered to buy it at a substantial discount. If the owner accepted, they worked to save the building. If the owner declined, they let it burn to the ground. Clearly, they discovered one sure way to find a motivated seller.

Banking on Investment

Today, thankfully, methodologies have evolved, but investors are still motivated by the same thing that drove Crassus: profits. It’s hard to imagine today’s business world without venture capital, mergers and acquisitions, underwriting, financing, trading and fund management. These vital activities all involve investment banking. As global markets and financial services have grown more integrated, competition has sharpened among investment bankers.

> “The lines are blurring between banking and brokerage and between money management and money lending.”

Today’s investment bankers offer one-stop financial services shopping for their clients and provide a major source of revenue for Wall Street firms. The line between commercial and investment banking has blurred, as clients increasingly look for one source that can provide all their lending needs. Since major Wall Street firms all operate in at least one overseas market, international securities activities have grown as well.

> “Financial engineering is the investment banker’s creativity successfully put into practice.”

Investment banking firms also provide:

- **Venture capital (VC)** – Most investment banks today have venture capital divisions, which typically provide capital and strategic guidance to new companies that may be growing rapidly, but are not yet large enough to gain access to public equity markets. These VC enterprises manage funds, sell companies and take companies public.
- **Securities underwriting** – Investment bankers help bring securities to the public market. All major Wall Street firms actively seek fixed-income underwriting opportunities. Investment banks also participate in the government securities market.
- **Asset securitization** – This refers to selling securities that are backed by the cash flows from a pool of financial assets, and it has meant a dramatic change in the way businesses are financed. This process began with mortgage pass-throughs, and then moved on to other types of assets. One recent addition to asset-backed securities is collateralized bond obligations, which convert junk bonds to investment-grade instruments.
- **Trading** – Many investment banks commit a lot of capital to proprietary trading.
- **Financial engineering** – Investment banks use different engineering techniques to match borrowers’ needs with investors, including hedging, funding, arbitrage, yield enhancement and tax initiatives.
- **Money management** – When Wall Street firms added fund management operations, they gained a revenue stream that is less cyclical than trading, underwriting, mergers or acquisitions.
- **Clearing and settlement** – Clearing is the business of processing a trade and establishing what the two trading parties owe each other. Settlement is the actual transfer of cash and securities that completes the deal.

Venturing to Obtain Capital

Many people don’t understand that a venture capital investment is only recouped when the portfolio company either goes public or sells out to another corporation. Typically, a VC fund’s general partner receives 20% of the profits, and the limited partners receive 80%.

> “As global markets have become more integrated, Wall Street firms have moved to establish a local presence in major financial markets around the world and to enhance this presence with broad cross-border capabilities.”

The VC fund has four life-stages:

- **Fundraising** – A general partner may spend a year getting investors and raising capital.
- **Investment** – When a company has passed muster to receive venture capital, it becomes a portfolio company, a phase that will last from three to seven years.
- **Growth stage** – During this prolonged period, the venture capitalist works with the entrepreneur to help the company grow.
- **Exit** – A VC firm can liquidate its position in a company by taking it public, by selling the portfolio company to a larger organization, or by going into bankruptcy. The VC firm expects an excellent return on its investment, somewhere in the 20% to 50% range. The bull markets skyrocketed venture capital firms' returns to 50% in 1995, and higher than 40% in '96 and '97. In '96, the venture capital market funded almost 1,700 firms with a total of $10 billion.

Mergers and Acquisitions

The three types of buyers who purchase companies are strategists, financiers and consolidators:

- Strategic buyers seek companies that will give them a competitive edge, such as geographic reach, an expanded customer base, or a better market share.
- A financial player, say a wealthy individual or the investment arm of a financial institution, seeks return on investment.
- The consolidator accumulates or organizes businesses in industries that once were characterized by independent, mom-and-pop shops.

> "A growing number of clients prefer to deal with a single financial advisor for all capital needs. Thus, many investment and commercial banks see the need to combine talents."

Whatever the reason for buying, mergers and acquisitions are a huge business – $1.719 trillion dollars during the 1980s, when investment bankers earned billions in M&A fees.

M&A Fees

While an investment bank's fees on a big merger deal are usually negotiable, the most common fee scale is the Lehman 5-4-3-2-1 formula. This means that 5% is paid on the first million dollars of the sale price, 4% on the next million, 3% on the third million, 2% on the fourth million, and 1% on the amount over $4 million dollars. For large transactions, the fees are less than 1% of the deal's value, still a tremendous amount of money.

Risk Arbitrage

If you owned 1,000 shares of stock in a company that just agreed to be acquired for $25 per share, how would you sell your securities and collect your money? After all, you wouldn't want to sell on the public exchanges, which would simply reflect the stock's current market price.

> "Rapid advances in information technology and greater cooperation among financial regulators have led to closer links in the international capital markets."

This is the entry cue for the risk arbitrage gurus. Risk arbitrageurs, or arbs, give shareholders a way to sell the stock at a price near the deal's announced tender price. When the arbs step forward as the middlemen, however, they essentially take on shareholder's risk. They naturally expect a handsome return for their exposure, because their risk is not hypothetical. For example, the arbs lost more than $1 billion following a series of failed takeover attempts involving UAL Corp. in 1989 and 1990.

The Price of Going Public

Taking a company public is very expensive. Costs vary, but can be as much as 10% on a $150 million stock issue, not including internal expenses, such as management's time. Some costs are ongoing, like the cost of Securities and Exchange Commission (SEC) compliance.

> “To maintain growth and profitability, and because the U.S. market is mature and, to some extent, over-banked, all major investment banks have expanded abroad.”

The public shell is a financing alternative. A shell is an inactive company whose securities are publicly traded. Merging into a shell, the easiest way to go public, saves time and money and obviates the need for SEC approval of the registration statement. The process is accomplished by purchasing a majority of the shell’s outstanding shares, which is usually less costly than other alternatives. Because some shell brokers have engaged in dubious practices, the SEC may close related loopholes.

Corporate Bonds

Corporate bonds – securities backed by companies, redeemable at maturity – are another source of capital. Large, high-quality borrowers use commercial paper (CP) for short-term credit. Medium term notes (MTN), another alternative, are designed to fill the gap between the short-term CP and long-term bonds. Because corporate debt securities fall under the Trust Indenture Act, a trustee is appointed to act on behalf of bondholders.

Foreign Listings on Wall Street

The advances in information technology mean that international markets are now closely linked. Foreign-based companies want to have Wall Street listings to gain access to large capital markets, while U.S. investors seek additional returns.

> “The ideal market is growing rapidly and has the potential to become enormous.”

Over the next few years, U.S. investors are expected to double their non-U.S. investments. Investment abroad is generally performed via an instrument called American Depository Receipts (ADRs), created by J. P. Morgan in 1927 to allow Americans to invest in Selfridge, a British retailer.

When a U.S. institution receives a request to invest abroad, it contacts a trusted broker in the country of the company in question and issues a buy order. The securities are then deposited with the bank’s local custodian. Once the custodian’s receipt of the shares is confirmed, the U.S. depository issues the appropriate number of American Depository Receipts to the investor.

European Markets

You could say that the first Eurodollar issue dates back to the post-World War II era, when Communist countries withdrew their huge reserves of U.S. dollars from U.S. banks because they feared government seizure. Instead, they poured this money into Europe, stimulating investment-banking activity.

> “The ideal product has many proprietary features that differentiate it from others offered by competing companies.”

In the late ’70s, spiraling inflation in the U.S. created another flight of capital out of U.S. banks and into European ones. Funds from OPEC oil surpluses flooded the market as well. Blue-chip multinationals turned to the Euromarkets for floating-rate loans. Today, such products include Eurobonds, Euro commercial paper and Euro medium-term notes, and Euromarkets represent an increasingly significant source of world capital.

Japanese Securities

The 1997 reforms that led to the so-called Japanese Big Bang – deregulation of Japanese commerce based on fair market and free entry principles – were expected to reshape its securities markets. The goal of the reforms was to upgrade Japan as an international market, rivaling London and New York. Today, foreign securities firms are becoming serious competitors to Japan’s "Big Three" firms.

Brady Bonds

Brady bonds are a major vehicle for investment in emerging countries. They were first issued in 1990 for Mexico and they involve the exchange of commercial bank loans into new collateralized bonds. To date, no country has defaulted on Brady bonds, which are backed by U.S. Treasury bonds. Investment in emerging markets is expected to grow.

Future Trends

The future of investment banking hinges on two major trends: globalization and one-stop shopping. Investors are trying to cross national borders to diversify and to seize new opportunities. U.S. companies are looking abroad to tap into equity markets and establish their presence overseas. Between 1990 and 1996, total U.S. underwriting of foreign companies rose from $18 billion to $76 billion.

> "Venture capital investing, buyouts, mergers and acquisitions are interrelated. They are an integral part of the investment banking business."

Eventually, banking, insurance, securities and fund management will be a single, united business. Corporate clients want their financial advisers to be able to address any need, rather than being forced to rely on multiple vendors. The lines between various financial services are blurring quickly, and the markets are rapidly becoming more integrated and global, particularly due to the rise in network information technology.

About the Author

K. Thomas Liaw is a finance professor at St. John's University, and operates a consulting practice in private equity and securities. He has published numerous articles and is often invited to speak about capital markets at executive business conferences. His principal areas of expertise include capital markets, trading, risk management and investment banking. His most recent book is *Foreign Participation in China's Banking and Securities Markets*.