Investment Banks

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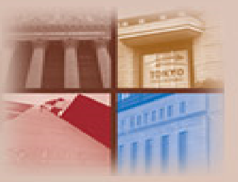
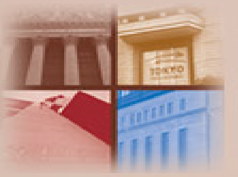
SKKU ISS 2019



Investment Banks

- Investment banks perform a variety of crucial functions in financial markets
  - Underwrite the initial sale of stocks and bonds
  - Deal maker in mergers, acquisitions, and spin-offs
  - Middleman in the purchase and sale of companies
  - Private broker to the very wealthy



Investment Banks

- Investment banks were essentially created in the U.S. by the passage of the Glass-Steagall Act. Prior to this, investment banking activities were part of large, money-center commercial banks.

- The lines between investment banks and commercial banks again begins to blur as legal separation between investment banks and commercial banks is no longer required.

Graham-Leach Act 1999

- President Clinton November 1999 signs Graham-Leach Bill which rescinded the Glass-Steagall Act of 1933.

- Consumer groups fought repeal of Glass-Steagall saying it would reduce privacy. Graham-Leach calls for a study of the issues of financial privacy

Corporate Finance Transactions

Investment banks play many roles in both the primary and secondary markets. We will focus on their roles in corporate finance transactions in below three areas:

- **Equity offerings**
  - Initial Public Offering (IPO)
  - Secondary Market Offering (SEO)
- **Mergers and Acquisitions**
  - Takeover
- **Leverage**
  - Leveraged Buyouts (LBO)
  - Bond Offering

Pros and Cons of an IPO

Advantages

- Stronger Capital Base
- Increases Financing prospects
- Better situated for acquisitions
- Owner Diversification
- Executive Compensation
- Increase company prestige

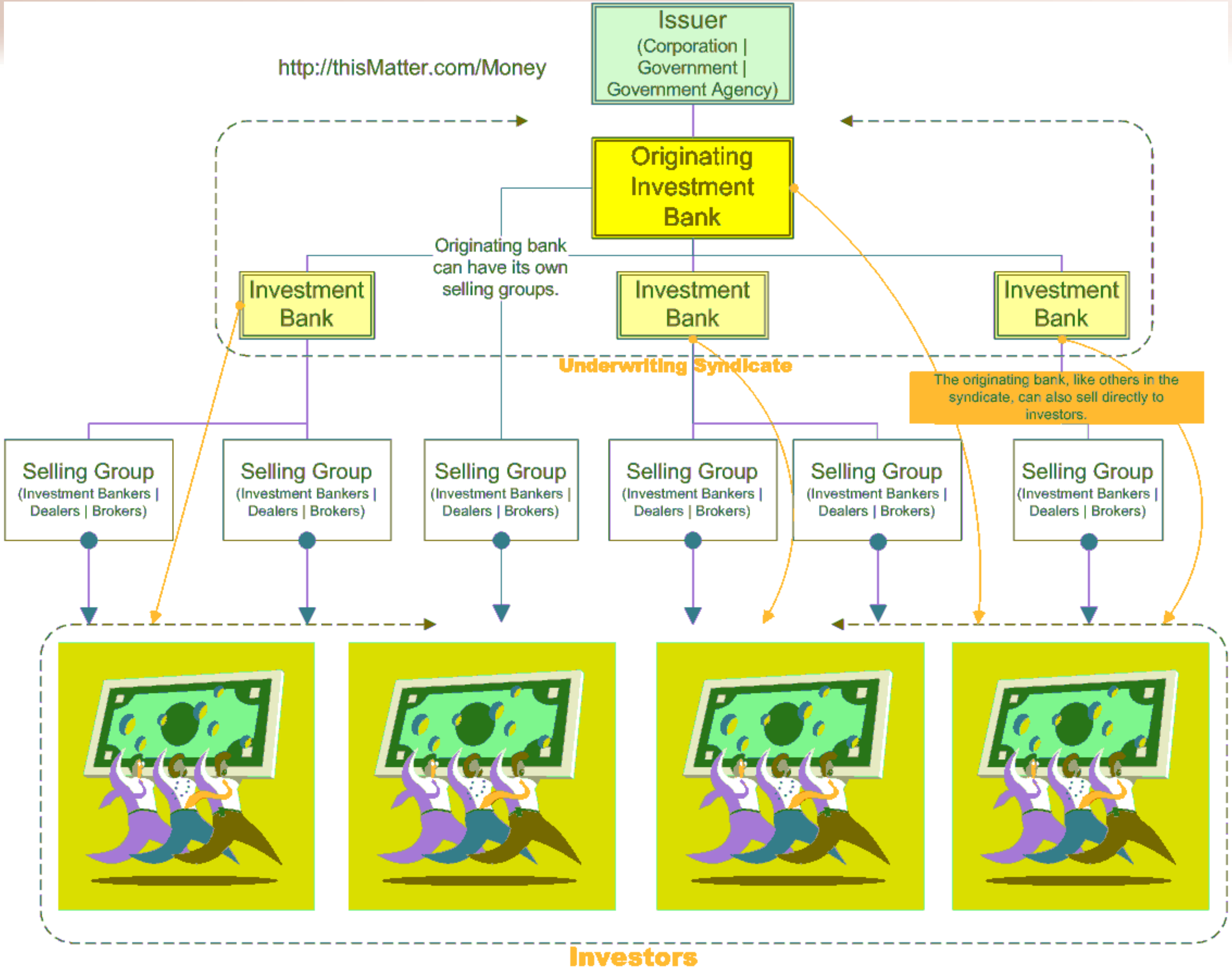
Disadvantages

- Short-term growth pressure
- Disclosure and Confidentiality
- Costs – initial and ongoing
- Restrictions on Management
- Loss of personal benefits
- Trading Restrictions

Moral Hazard Problem Mitigated by Investment Banks

- Firms have incentive to issue shares when they know their earnings are only temporarily high.
- This problem can be “solved” by resorting to bank loans instead of new equity
- Problem can also be solved by issuing security with an investment bank that has a reputation to protect.
- Studies show that investment banks that repeatedly underprice or overprice issues suffer a market share loss afterwards.

IPO Process



http://thisMatter.com/Money
Issuer
(Corporation | Government | Government Agency)
Originating Investment Bank
Originating bank can have its own selling groups.
Investment Bank
Investment Bank
Investment Bank
Underwriting Syndicate
The originating bank, like others in the syndicate, can also sell directly to investors.
Selling Group (Investment Bankers | Dealers | Brokers)
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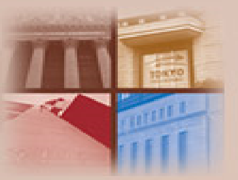
Investors

1st Step of an IPO

- ***The Pitch (Pitchbook)***
- ***Originating/ Hiring the managers***
- ***("Beauty Contest")/ Pitching***
  - ➢Making a Valuation (mix of art and science)
  - ➢ Highest Valuation vs. Best-qualified manager
  - ➢Determine structuring and distribution

The **<u>Pitchbook</u>** includes:
• the bank's reputation, which can lend the offering an aura of respectability
• the performance of other IPOs managed by the bank
• the prominence of a bank's research analyst in the industry, which can tacitly guarantee that the new
public stock will receive favorable coverage by a listened-to stock expert
• the bank's expertise as an underwriter in the industry

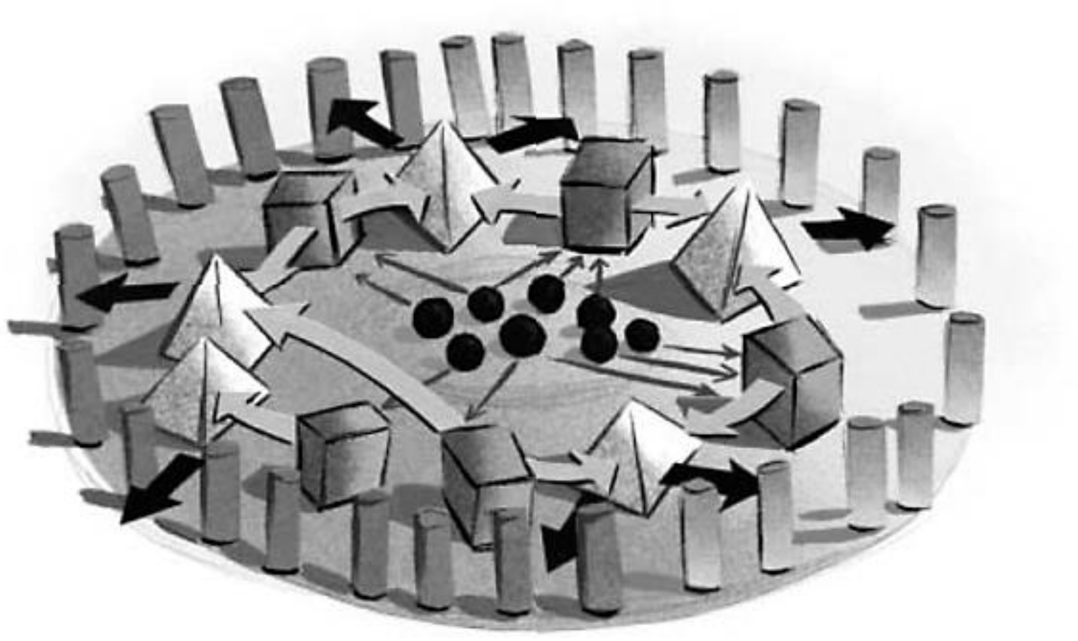


2^{nd} Step of an IPO

- ***Underwriting* (reason: size)**
  - ➢ form the syndicate and selling group for joint distribution of the offering
  - ➢ Members of the syndicate make a firm commitment to distribute a certain percentage of the entire offering and are held financially responsible for any unsold portions
  - ➢ Selling groups ("best effort") of chosen brokerages, are formed to assist the syndicate members meet their obligations
  - ➢ most common type of underwriting, firm commitment, the managing underwriter makes a commitment to the issuing corporation to purchase all shares being offered. If part of the new issue goes unsold, any losses are distributed among the members of the syndicate.

The Syndicate

The Structure of Syndication



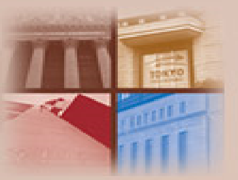
Vital link between salespeople and corporate finance. Syndicate exists to facilitate the placing of securities in a public offering, a knock-down drag-out affair between and among buyers of offerings and the investment banks managing the process. In a corporate or municipal debt deal, syndicate also determines the allocation of bonds.

Pricing of an IPO

- Lead managers help to decide on an appropriate price at which the shares should be issued.
- There are two ways in which the price of an IPO can be determined:

1. the company, with the help of its lead managers, fixes a price or
2. the price is arrived at through the process of *book building.*

Book Building is a process to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process. In case of oversubscription the *greenshoe (over-allotment) option* is triggered. It can vary in size up to 15% of the original number of shares offered



3rd Step of an IPO

- ***Due Diligence and Drafting***
  - ➢ understanding the company's business as well as possible scenarios (Due Diligence)
  - ➢ filing the legal Documents as required by the Regulator (Prospectus)
  - ➢ Registration Statement:
  - ➢ Business product/service/markets
  - ➢ Company Information
  - ➢ Risk Factors
  - ➢ Proceeds Use
  - ➢ Officers and Directors
  - ➢ Related party transactions
  - ➢ Identification of your principal shareholders

4th Step of an IPO

- ***Marketing***
  - “*Roadshow*” or “*Baby Sitting*”
  - marketing phase ends with the placement of the stock
  - gathering "*indications of interest*"
  - An indication of interest does not obligate or bind the customer to purchase the issue, since all sales are prohibited until the security has cleared registration.
  - final prospectus is issued
  - The final prospectus contains all of the information in the preliminary prospectus (plus any amendments), as

Underwriting Stocks and Bonds

- The investment banker *purchases* the entire offering at a predetermined price and then resell the offering (securities) in the market. The services provided during this process include:
  - Giving Advice
  - Filing Documents
  - Underwriting, Best Efforts, or Private Placement

Private Placement

- Private Placements: The entire issue is sold to a small, select group of investors. This is rarely done with equity issues but is common with equity sales.
- Sold only to “sophisticated” investors, exempt from SEC registration.
- Regulation D: Private issues cannot be advertised, defines sophisticated investors
- SEC has provided that privately placed securities cannot be sold for two years after purchase.
- SEC Rule 144a April 1990 eliminates two-year holding period for institutions with over $100 million in the security

Underwriting Stocks and Bonds

- Giving advice
  - Explaining current market conditions in to help determine which type of security (equity, debt, etc.) to offer
  - Assisting in determining when to issue, how many, at what price (more important with IPOs than SEOs)

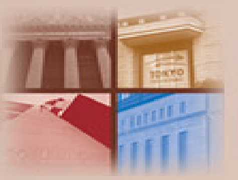
Filing Documents

- SEC registration (filing) is required for issues greater than **$1.5 million** and with a maturity greater than **270 days**.
- A portion of the registration statement known as the **prospectus** is made available to the public.
- Debt issues require several additional steps, including acquiring a credit rating, hire a bond counsel, etc.
- For equity issues, the investment banker may also arrange for the securities to appear on one of the

Two Types of Offerings

- **Firm commitment offering** (synonym: **Bought deal**): The underwriter agrees to buy all shares that are not sold

- **Best efforts**: the underwriter says that if the issue is not sold, deal collapses. It is an alternative to a firm commitment, the underwriter does not buy the issue, but rather makes its “best effort” to sell the entire issue.



Underwriting Stocks and Bonds

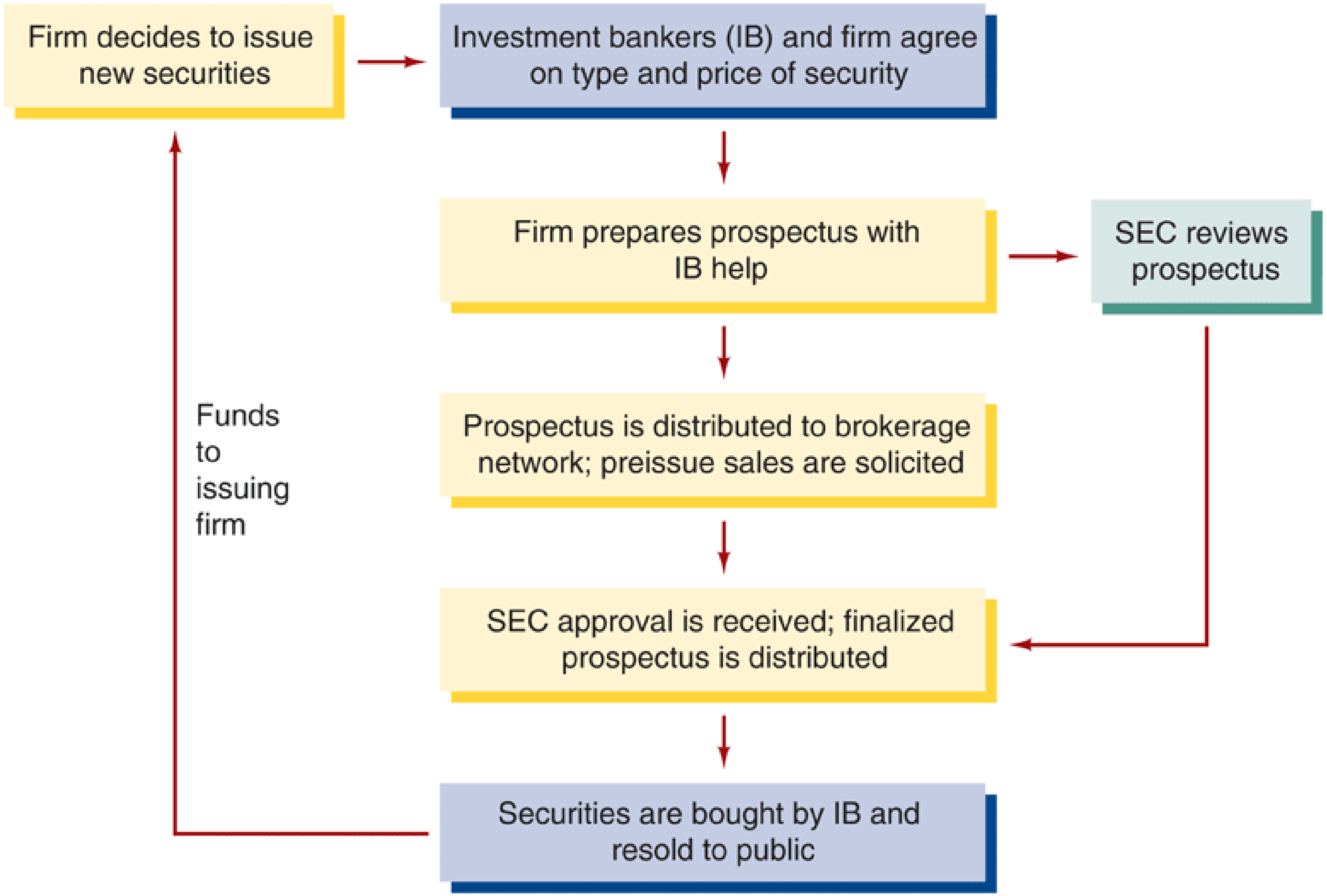
- Underwriting (firm commitment)
  - The investment banker purchases the entire offering at a fixed price and then resells the offering to the market.
  - An underwriter may form an underwriting **syndicate** to diffuse part of the underwriting risk.
  - Placement of a **tombstone** in the financial press.

Underwriting Stocks and Bonds

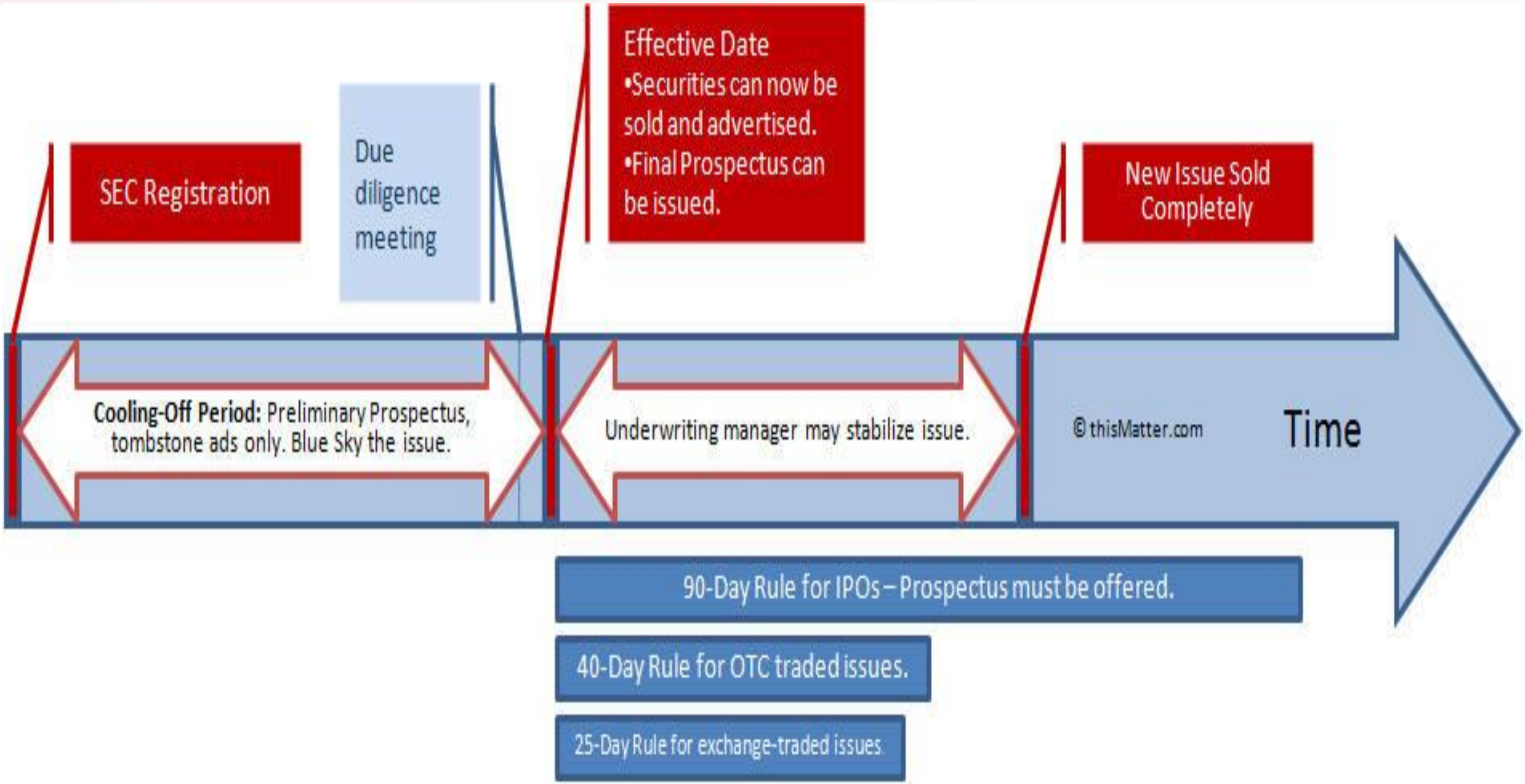
- The goal of underwriting is for all of the shares in an offering to be spoken for. However, this may not occur.
  - **Fully subscribed**: all shares are spoken for
  - **Undersubscribed**: underwriting syndicate unable to generate interest in all of the available shares
  - **Oversubscribed**: interest in more shares than are available (may lead to rationing).

Underwriting Stocks and Bonds

Using Investment Bankers to Distribute Securities to the Public



Timelline for an IPO (US)



The Underwriting Process I

- Prefiling period
- Advise issuers about their choices
- Agreement among underwriters, designates manager, fees
- Filing of registration statement with SEC, begins cooling-off period
- Cooling off period – distribute preliminary prospectus (red herring), nothing else

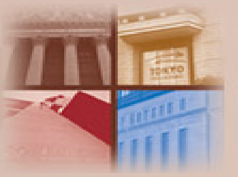
The Underwriting Process II

- Call prospective clients for indication of interest
- Due diligence meeting between underwriter and corporation
- Decide on offering price,
- underwriting agreement, which underwriter sells what
- Dealer agreement, dealers purchase from underwriters at a discount from public price
- Effective date
- Support the price in the aftermarket

Investment Bank Fees of an IPO

- The price paid to the issuer is known as the ***underwriting proceeds.*** The spread between the ***POP (Public Offering Price)*** and the underwriting proceeds is split into the following *components:*
- Manager's Fee - goes to the managing underwriter for negotiating and managing the offering. (10% - 20% of the spread)
- Underwriting Fee - goes to the managing underwriter and syndicate members for assuming the risk of buying

Often the managing underwriter will need to stabilize the price to keep it from falling too far below the POP.



Final Touch of the IPO - The Tombstone

- Newspaper announcements of securities’ issues, listing underwriting syndicate
- Why called tombstones? Origin of term forgotten. Resemblance?
- The only kind of ad allowed during cooling-off period
- Cross between birth announcement and obituary. Tombstones appear after the securities have already been sold, but of course they are now on the market.
- Investment bankers love to read them


facebook
$16,006,877,370
Initial Public Offering
421,233,615 Shares


November 2013
$2.1 Billion Initial Public Offering
80,500,000 Shares
$26.00 per Share
Bookrunners
Goldman Sachs
Morgan Stanley
J.P.Morgan
Bank of America Merrill Lynch
Deutsche Bank
Allen & Company
Twitter @twitter
We've confidentially submitted an S-1 to the SEC for a planned IPO.
Twitter @twitter
Now back to work.
Twitter @twitter
Our S-1 will be filed publicly with the SEC momentarily.
We just priced our IPO.
Twitter @twitter
#Ring!


$5,613,195,114
BLACKROCK
Sale of Barclays's BlackRock Stake
$4,613,195,040 Follow-On Offering
28,832,469 Secondary Shares Common Stock
$1,000,000,154 Direct Repurchase by BlackRock
6,377,552 Shares Series B Preferred Stock
Joint Bookrunners
BARCLAYS
Morgan Stanley
Bank of America
Merrill Lynch
May 22, 2012

Variations on the Usual Underwriting Process

- Auction Process (competitive bidding underwriting) various syndicates bid on the issue
- Preemptive rights offering: existing shareholders have rights to buy issue below market value
- Directly Public Offering (DPO): Company itself sells its securities directly to public, usually over the web. Small firms. Example: Internet Ventures, a web service provider, raised $3.8 million in 1998 by advertising the securities to its customers on the web.

IPO Underpricing

- Price tends to jump up immediately after an IPO is issued.

- Apparently “leave money upon the table”.

- Commonly observed “IPO underpricing”

Poor Long-Run Performance of IPOs

- Jay Ritter, Journal of Finance, 1991

- Although average IPO earns a +16% return on the first day, this return tends to be offset over the next three years.

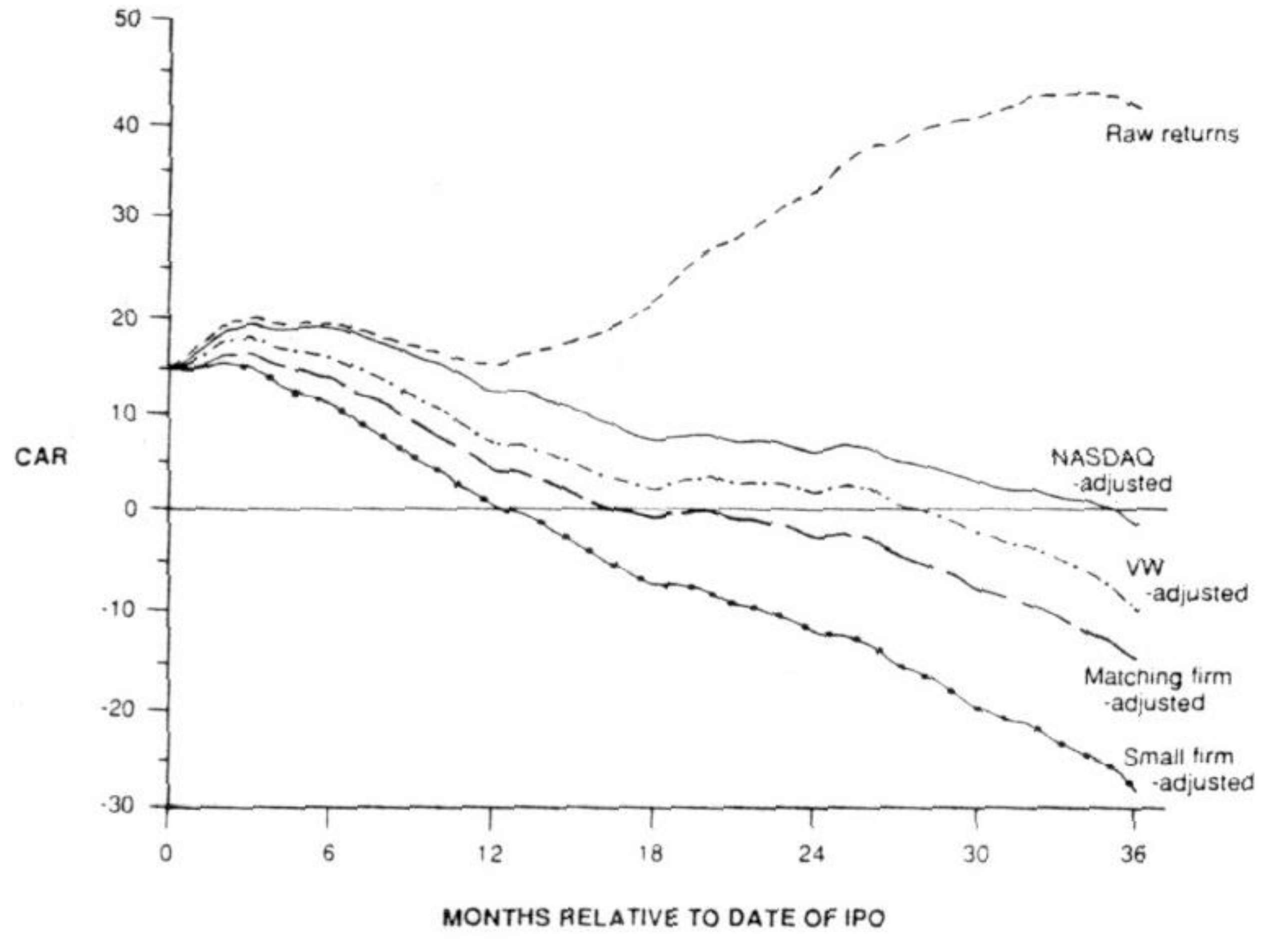


Figure 1. Cumulative average adjusted returns for an equally-weighted portfolio of 1,526 initial public offerings in 1975–84, with monthly rebalancing. Five CAR series are plotted for the 36 months after the IPO date: 1) no adjustment (raw returns), 2) CRSP value-weighted NASDAQ index adjustment (NASDAQ-adjusted), 3) CRSP value-weighted Amex-NYSE index adjustment (VW-adjusted), 4) matching firm adjustment (matching firm-adjusted), and 5) lowest decile of NYSE market capitalization index adjustment (small firm-adjusted). Month 0 is the initial return interval.

Why This Performance of IPOs?

- Impresario Hypothesis: analogy to sellers of tickets to concerts

Survey of IPO Investors

- "*Do you think that investors expect reputable underwriters to take some account of true investment value in deciding the offering price in an IPO, rather than just the price the market will bear on the day of the offering?*"
  - 84% agree
- "*Have you done any calculations of what the true fundamental value of a share in the company was, and compared the price of a share with this value?*"
  - 80% no.

Secondary Market Offering (SEO)

- ***A follow-on offering or SEO*** is an issuance of stock subsequent to the company's IPO. A SEO can be either of two types (or a mixture of both): dilutive ("new" shares) and non-dilutive ("old" shares) (as rights issue). Furthermore it could be a cash issue or a capital increase in return for stock.
- ***The Process: The SEO process changes little from that of an IPO, and actually is far less*** complicated. Since underwriters have already represented the company in an IPO, a company often chooses the same managers, thus making the hiring the manager or beauty contest phase much simpler. Also, no valuation is required (the market now values the firm's stock), a prospectus has already been written, and a roadshow presentation already prepared. Modifications to the prospectus and the roadshow demand the most time in a SEO
- ***Market Reaction:*** *What happens when a company announces a secondary offering indicates the market's* tolerance for additional equity. Because more shares of stock "dilute" the old shareholders, the stock price usually drops on the announcement of a SEO. Dilution occurs because earnings per share (EPS) in the future will decline, simply based on the fact that more shares will exist post-deal. And since EPS drives stock prices, the share price generally drops.

Bond Offerings

- ***The bond offering process*** resembles the IPO process. The primary difference lies in:

(1) the focus of the prospectus (a prospectus for a bond offering will emphasize the company's stability and steady cash flow, whereas a stock prospectus will usually play up the company's growth and expansion opportunities), and

(2) the importance of the bond's credit rating (the company will want to obtain a favorable credit rating from a debt rating agency like S&P or Moody's, with the help of the credit department of the investment bank issuing the bond; the bank's credit department will negotiate with the rating agencies to obtain the best possible rating). Clearly, a firm issuing debt will want to have the highest possible bond rating, and hence pay a low interest rate.

Equity Sales

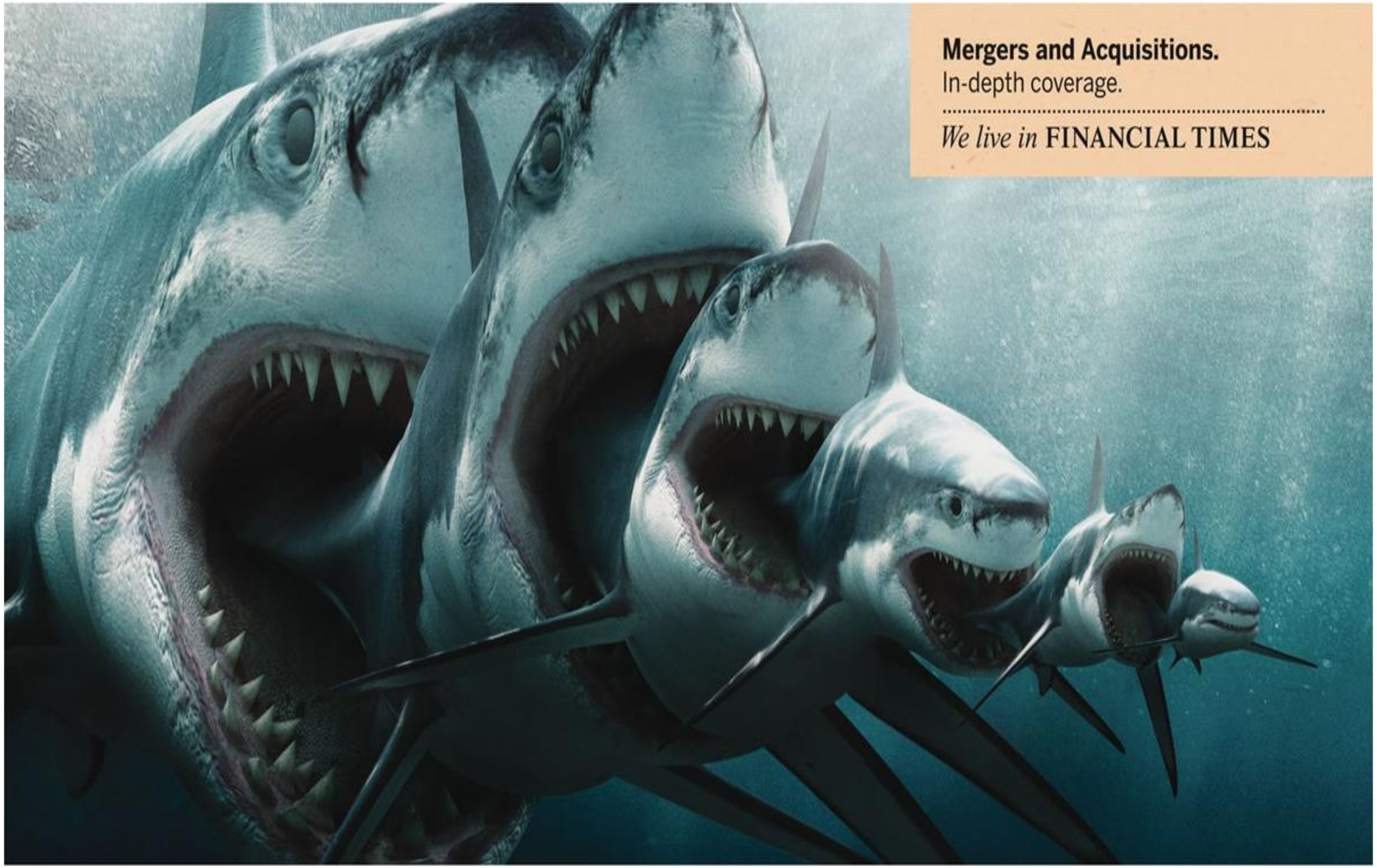
- When a firm sells an entire division (or maybe the entire company), enlisting the aid of an investment banker.
  - Assists in determining the value of the division or firm and find potential buyers
  - Develop confidential financial statements for the division for prospective buyer (**confidential memorandum**)
  - Prepare a **letter of intent** to continue, assist with **due diligence**, and help reach a **definitive**

Mergers and Acquisitions

- Investment bankers may assist both acquiring firms and potential targets (although not both in the same deal).

- Deal may be a *hostile* takeover, where the target does not wish to be acquired.

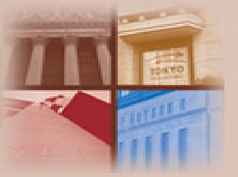
- Investment bankers will assist in all areas, including deal specifics, lining up financing, legal issues, etc.


Mergers and Acquisitions.
In-depth coverage.
We live in FINANCIAL TIMES

Types of Acquisitions

- ***Friendly:*** the companies cooperate in negotiations
- ***Hostile:*** target is unwilling to be bought or the target's board has no prior knowledge of the offer
- ***Reverse Takeover:*** a smaller firm will acquire management control of a larger company and keep its name for the combined entity.
- ***Reverse Merger:*** a deal that enables a private company to get publicly listed in a short time period. It [illegible] publicly listed shell company, usually one with no

Achieving acquisition success has proven to be very difficult, while various studies have shown that 50% of acquisitions were unsuccessful. The acquisition process is very complex, with many dimensions influencing its outcome [illegible]



Categories of Mergers

- ***Congeneric:*** firms in the same general industry, but no mutual buyer/customer or supplier relationship, such as a merger between a bank and a leasing company. (i.e. Prudential's acquisition of Bache & Company)
- ***Conglomerate:*** companies that have no common business areas.
- ***Product-extension merger***: Two companies selling different but related products in the same market (eg: a cone supplier merging with an ice cream maker).
- ***Consolidation mergers***: a brand new company is formed and both companies are bought and combined under the new entity.
- ***Accretive mergers:*** are those in which an acquiring company's earnings per share (EPS) increase. An alternative way of calculating this is if a company with a high price to earnings ratio (P/E) acquires one with a low P/E.

The occurrence of a merger often raises concerns in antitrust circles. Regulatory bodies such may investigate anti-trust cases for monopolies dangers, and have the power to block

Investment Bankers' Annual Salary

Title	Base Salary	Bonus	Total Remuneration
Analyst	$85k - $100k	$50k - $100k	$125k - $200k
Associate	$100k - $120k	$80k - $130k	$180k - $250k
Vice President	$120k - $150k	$100k - $250k	$220k - $400k
Managing Director	$300k - $1M	$200k - $10M+	$500k - $10M+

Data source: https://corporatefinanceinstitute.com

“Everything should be made as simple as possible, but not simpler.” - *Albert Einstein*