Ned Krastev

# Investment Banking

## Course Notes

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# Commercial vs. Investment Banks

*The two types of banking institutions*


| Commercial Banking | VS | Investment Banking |
|---|---|---|
| Commercial banking is typically known as the practice of accepting deposits and providing loans. The core activity of commercial banks is to gather funds from individuals and businesses and then extend credit to borrowers. | Description | Investment banks engage in a range of sophisticated activities, including initial public offerings (IPOs), merger and acquisition (M&A) advice, corporate restructuring, trading, and asset management. |
| Commercial banking services include accepting deposits, providing loans, issuing bank checks, managing cash and Treasury management. | Services | Capital Markets (IPOs, SEOs, Private Placements), M&A, Restructurings, Trading and Brokerage, Asset Management |
| Retail Clients, Small Corporate Clients, Medium and Large Corporate Clients | Clients | HNWI, Medium and Large Corporations, Institutional Investors, Hedge Funds, Private Equity Funds |

# Universal vs. Pure Investment Banks

*One-stop-shop or a specialized shop?*

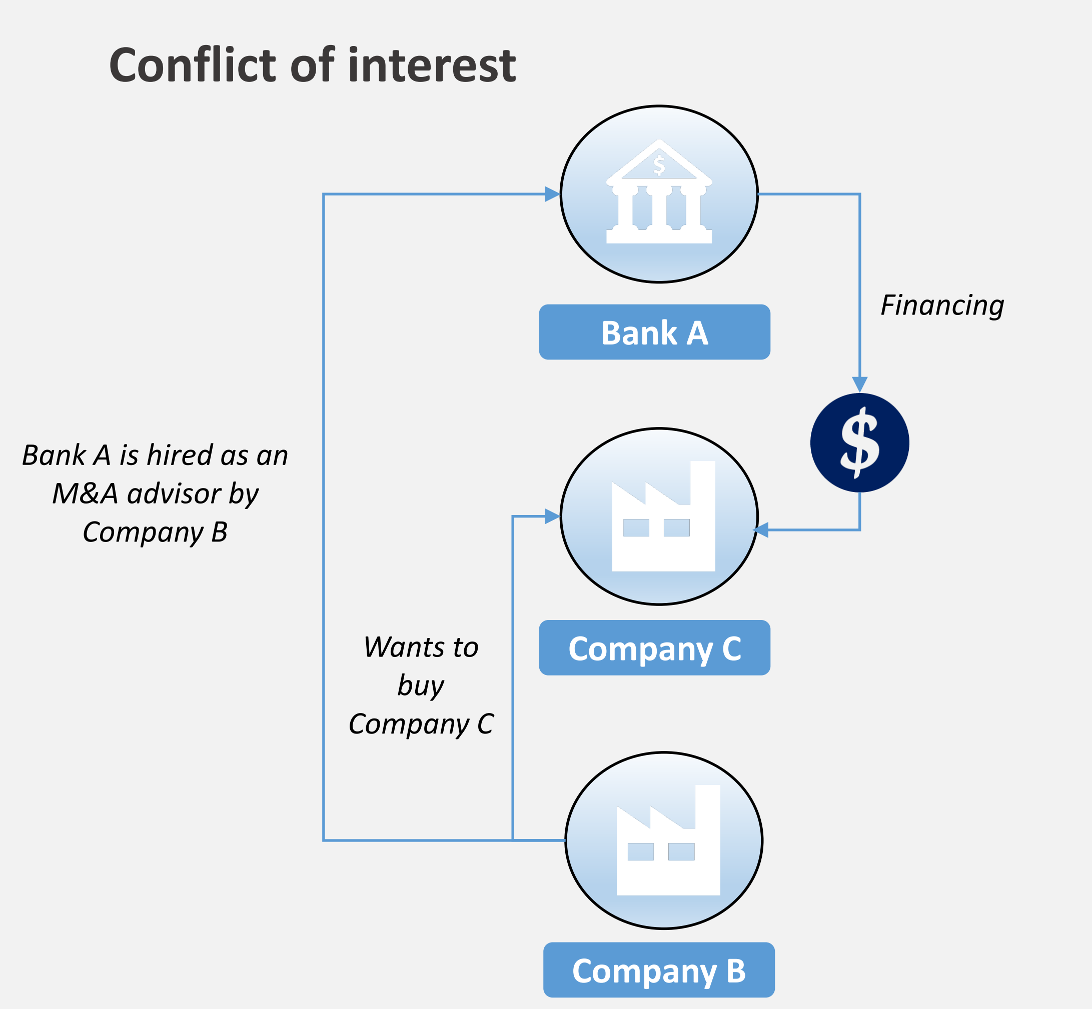
  

| Universal Banks | VS | Pure Investment Banks |
|---|---|---|
| Universal banks offer a combination of commercial and investment banking services. | Description | A pure investment bank only provides investment banking services and does not offer commercial banking product such as deposit-taking and lending. |
| Universal banks have the ability to offer a wide range of products to their clients, providing a one-stop-shop for all banking needs. | Competitive Advantage | Specialization, focus, and historical relationships; Superb services offered to clients |
| J.P. Morgan Chase, HSBC, Credit Suisse, Societe Generale, BNP Paribas, Barclays, Bank of America Merrill Lynch | Examples | Goldman Sachs, Morgan Stanley, Lazard |

# Conflicts of Interest

***An agent may act counter to the interests of their client to protect their own interests.***

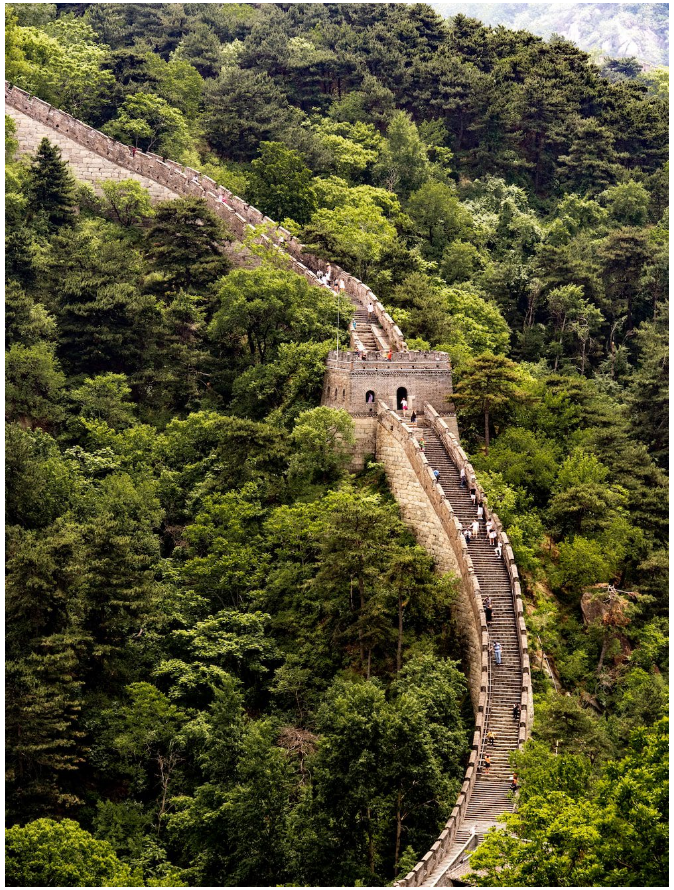
In the scenario described, Universal Bank A, which offers both commercial and investment banking services, has financed Company C. When another firm, Company B, expresses interest in acquiring Company C, they hire Universal Bank A as an advisor for the transaction. Due to their knowledge of Company C's business, Universal Bank A may have concerns about the ability to recover the loan they provided to Company C. In this case, it would be in their best interest to assist Company B in acquiring Company C in order to recoup the loan and earn an advisory fee. However, this creates a conflict of interest between the bank's own interests and those of their client, Company B.

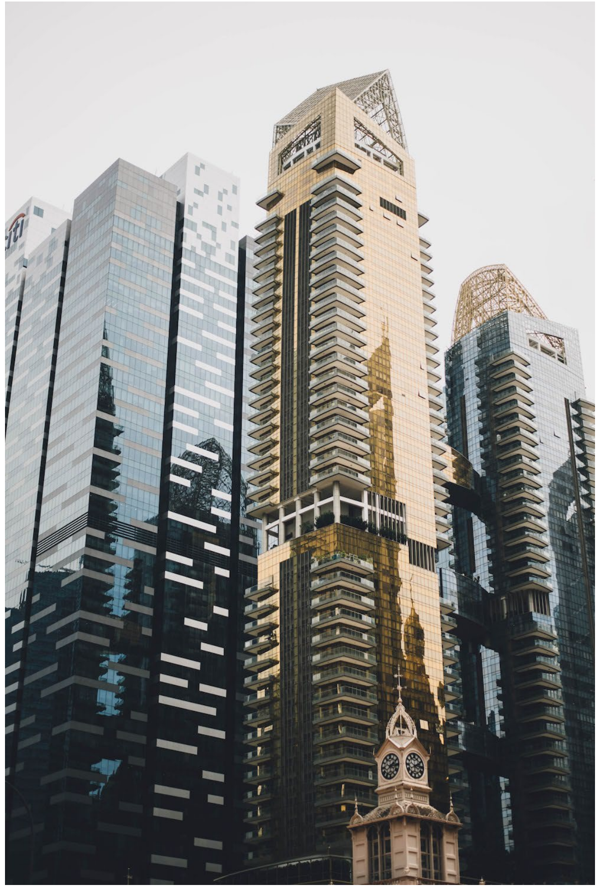


# Chinese Walls

***Separate functions within an organization that can have a potential conflict of interest***

Chinese Walls serve as a barrier between different divisions of an organization to prevent conflicts of interest from arising. They ensure that client information remains confidential and is only shared with authorized personnel within the firm. Employees working in different departments of an investment bank, for example, must act as if they are part of separate organizations to uphold the integrity of these Chinese Walls.





# Investment Banking: Course Notes

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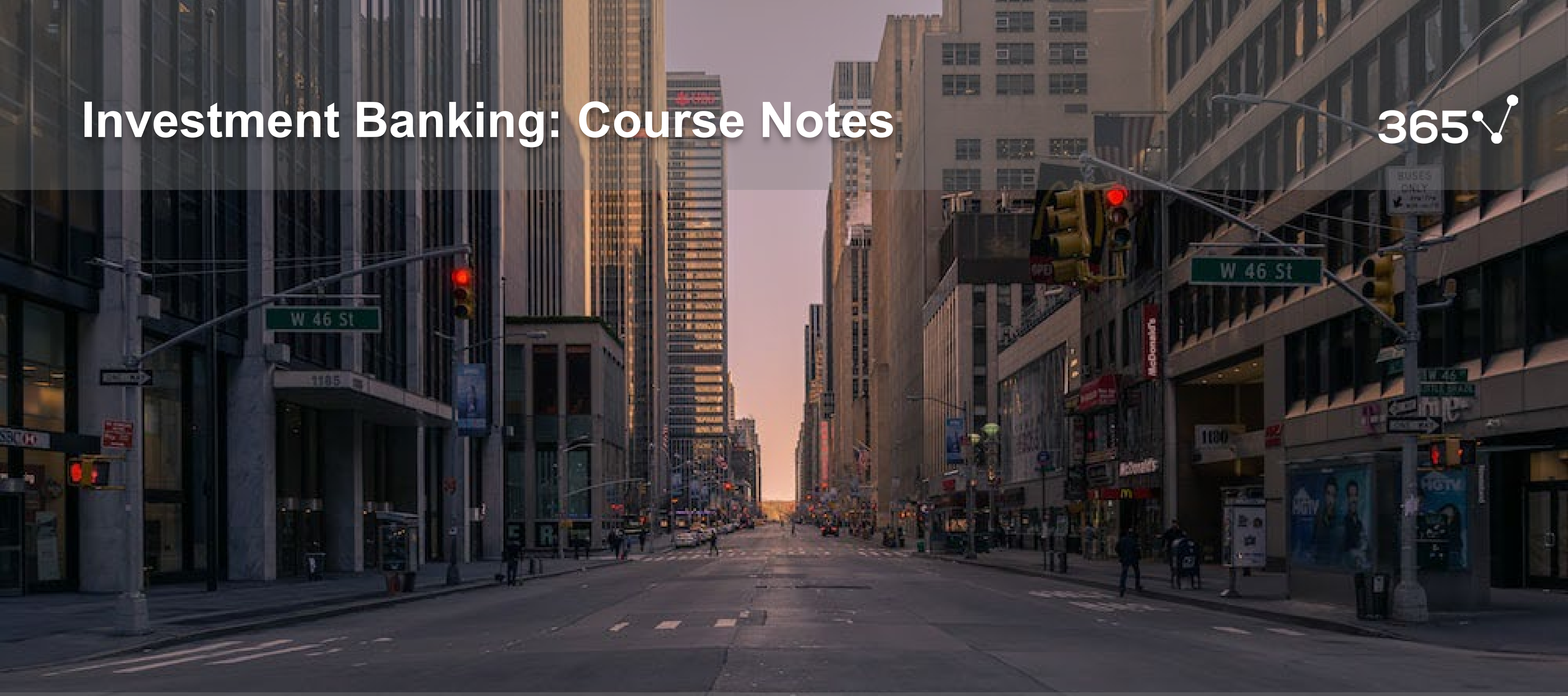


## The four main divisions in Investment Banking

# Capital Markets

*Working with companies that seek to raise capital*

Capital markets are a captivating aspect of investment banking, crucial for companies seeking to go public or issue debt to the public.

## Issuing Equity (ECM)

Going public marks a significant milestone for a company. The Equity Capital Markets (ECM) division of an investment bank works with companies that are going to be listed. These businesses have grown to become large entities that are ready for public investment. Upon listing, shares are sold to institutional and retail investors, granting them influence over company leadership and board composition.

## Issuing Debt (DCM)

Investment banks' Debt Capital Markets division assists companies seeking to issue debt securities, called bonds. The process is similar to an equity offering, with many of the same players involved. The key distinction is that bonds can also be issued by sovereign countries and other government entities. Bonds are typically easier to price than equity, as companies issuing them have a credit rating (a measure of creditworthiness provided by independent credit rating agencies).

# Advisory

*Assist clients in M&A deals and Restructuring procedures*

Advisory is a division comprised of experts in Corporate Finance, capable of handling complex transactions like M&A and Corporate Restructuring for clients.

## M&A

M&A stands for Mergers and Acquisitions. An acquisition occurs when a company buys another company's shares or assets, while a merger happens when the acquiring company absorbs the target company, which then ceases to exist. M&A deals hold significance for companies, as top management understands the cost savings of acquiring existing assets rather than developing them internally.

## Restructuring

Corporate distress occurs when a company is unable to meet its debt obligations and is at risk of bankruptcy. This can stem from operational difficulties or financial problems, despite a profitable core business. In these cases, a private workout or formal bankruptcy procedure in court are the two main options. Lenders prefer private workouts, as they result in quicker outcomes and a higher recovery rate.

# Trading and Brokerage

*Buying and selling of financial instruments*

Buying and selling securities with the investment bank's funds or on behalf of clients.

## Trading

Proprietary trading refers to the investment bank using its own funds to purchase financial instruments for a limited time, with the goal of selling them for a profit. This is often profitable, as investment banks have a strong understanding of financial markets and short-term profitable trades.

## Brokerage

Asset Managers and institutional investors use brokerage services provided by investment banks. The banks sell securities to these clients and make a profit from the bid/ask spread - the difference between the buying and selling prices of a security.

# Asset Management

***Generate returns for clients by investing their money in various financial instruments***

Investment banks provide asset management services to institutional investors, such as pension funds and investment firms, and high net-worth individuals.

## Institutional Investors

Institutional investors like pension funds and investment companies partner with investment banks for access to exclusive investment options like structured products, equity, fixed income, private equity, and real estate.

## HNWI (High Net-Worth Individuals)

Investment banks cater to high net-worth individuals (HNWIs) with over $10 million in investable income by providing specialized services like deposit taking and payments, discretionary asset management, tax advisory, and sometimes concierge services.

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# Investment Banking: Course Notes

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## Capital Markets

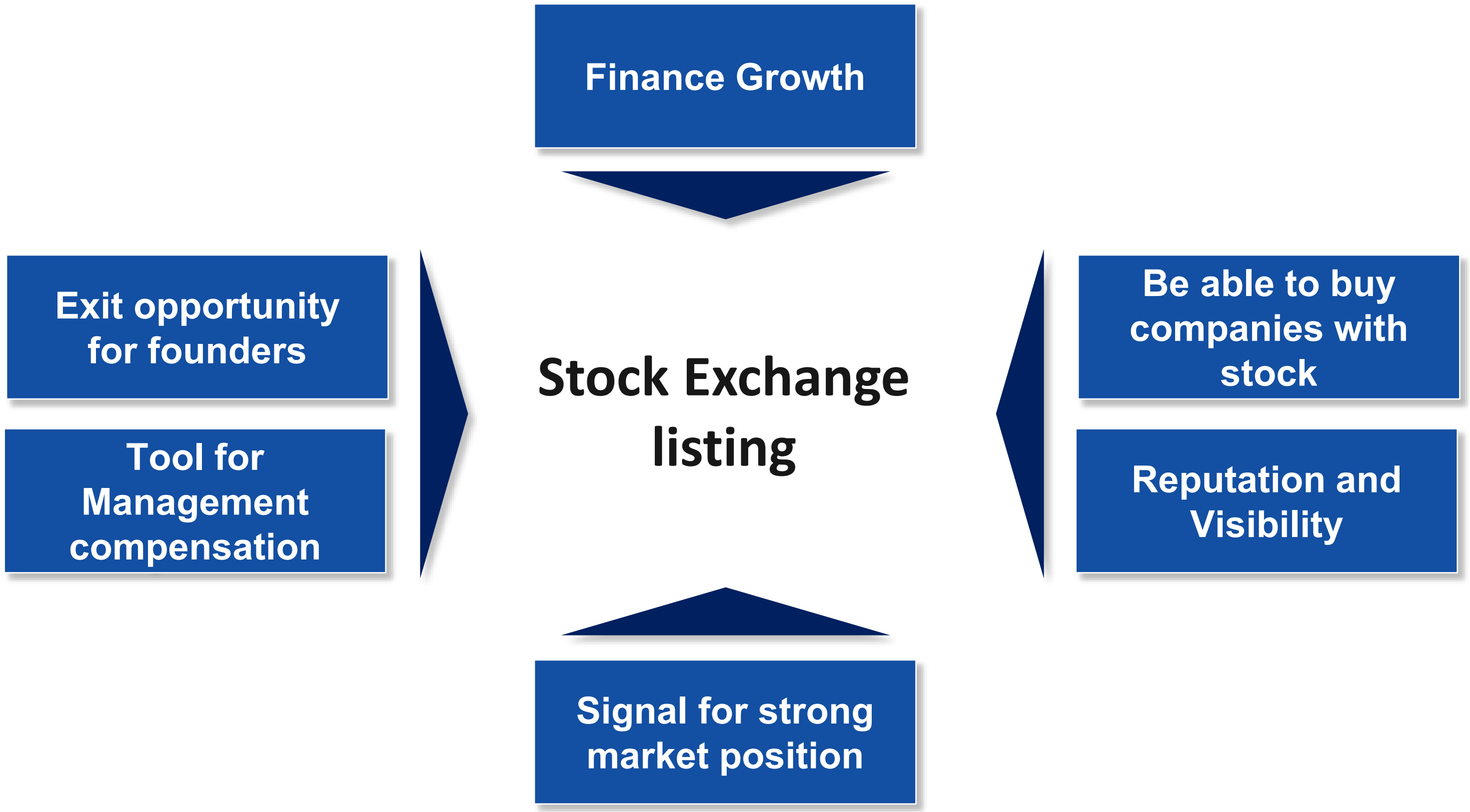
# Capital Markets Services

*Types of services and activities within an investment bank's ECM and DCM divisions*

| Category | | Product type | Description | Type of investors |
|---|---|---|---|---|
| Equity Offerings | 1 | **Initial Public Offerings** | The initial public offering (IPO) of a company's stock, where it is listed on a stock exchange and made available to investors at a set price range | Private Investors & Sophisticated Investors |
| | 2 | **Seasoned Public Offerings** | Transactions in which publicly-listed firms raise additional equity capital | Private Investors & Sophisticated Investors |
| | 3 | **Private Placements** | Raising equity through limited offering to sophisticated investors, avoiding the need for full registration procedures required in initial public offerings (IPOs). | Sophisticated Investors |
| Debt Offerings | 1 | **Bond Offerings** | Issuance of bonds by public authorities, credit institutions, companies and supranational organizations. Process is similar to equity offerings although pricing is easier | Private Investors & Sophisticated Investors |
| | 2 | **Securitization** | Receivables under some form (credits, rents, leases) are packaged together and sold as a security to investors. Often these securities are referred to as Asset Backed Securities (ABS) | Private Investors & Sophisticated Investors |
| | 3 | **Loan syndication** | Providing a loan as a group of banks (a syndicate). | Financial Institutions |

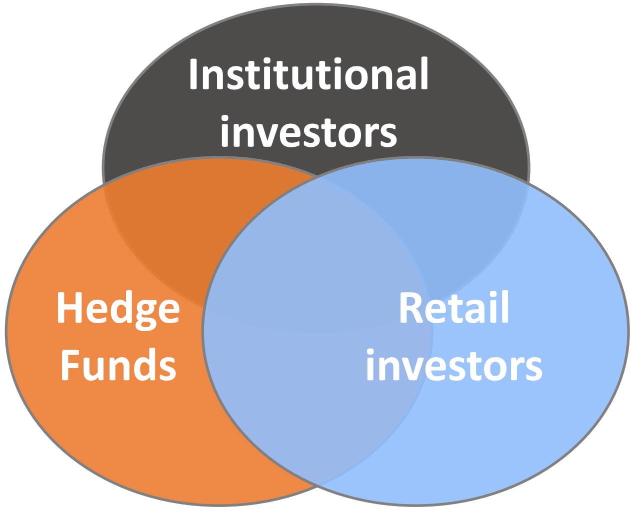
# Why Companies Go Public?

*Motivations for a company's decision to go public via listing on a stock exchange.*



# Who are the investors and what do they look for?

*Types of investors*




**The above categories of investors differ from each other in their:**

- **Investment horizon**
- **Return expectations**
- **Risk profile**
- **Sophistication**

***Nevertheless, investors are interested in similar type of stories:***

- Success stories
- Strong leadership
- Growth potential
- Modest valuation (Lower Price Range)
- Companies with positive Cash flows
- Solid market position

**High demand for the IPO**

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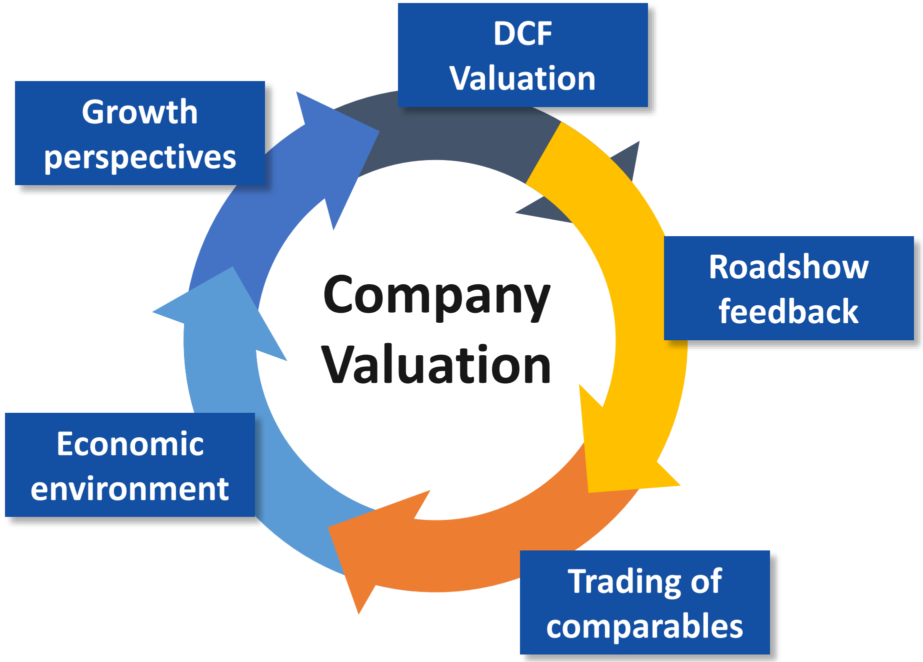
# Pricing mechanisms of an IPO

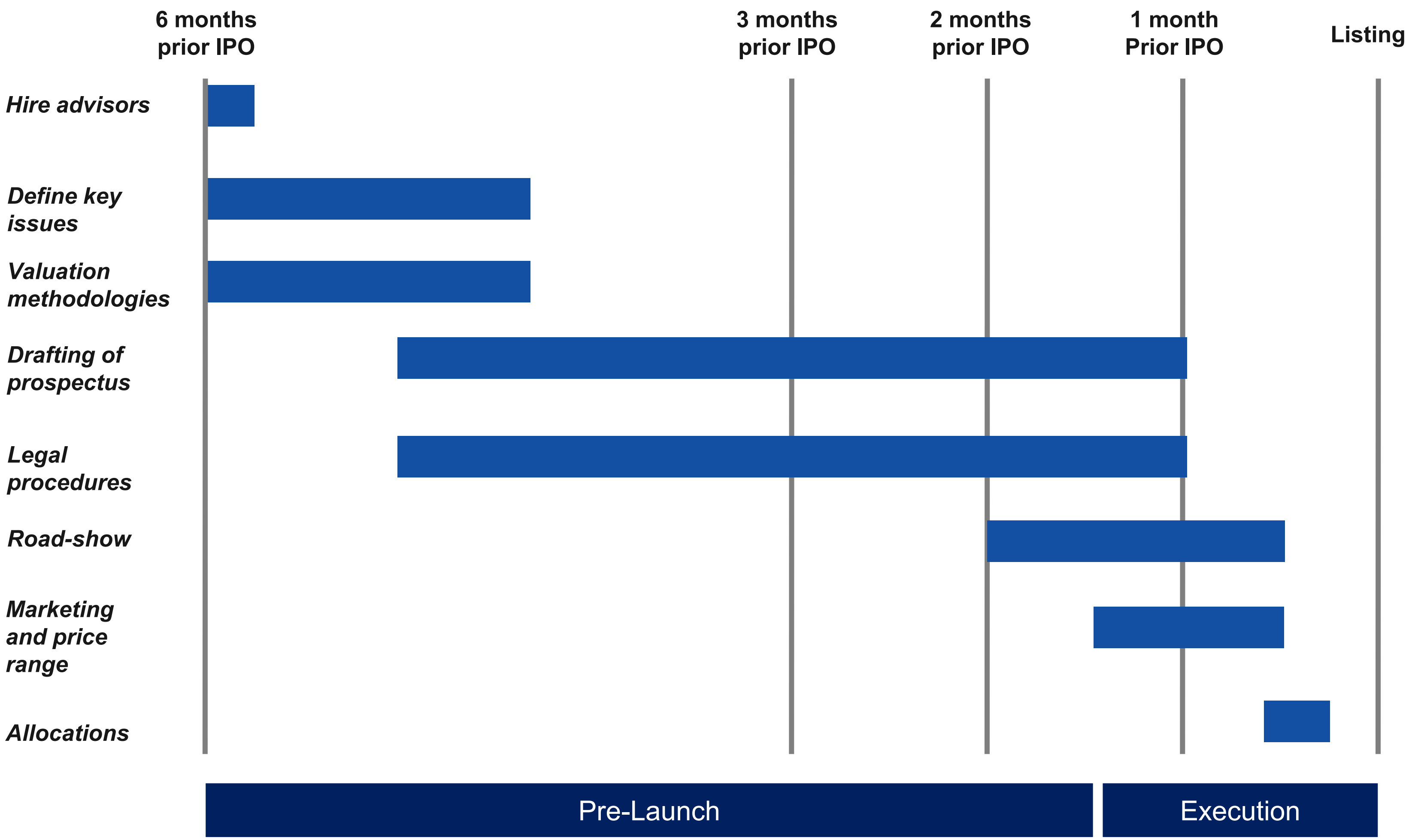
*Factors that determine the price of a company that is going public*

**The pricing for an IPO is determined by various factors with the aim of offering a small discount to the company's value to satisfy investors and boost post-launch trading of the shares.**



# Timetable of an IPO

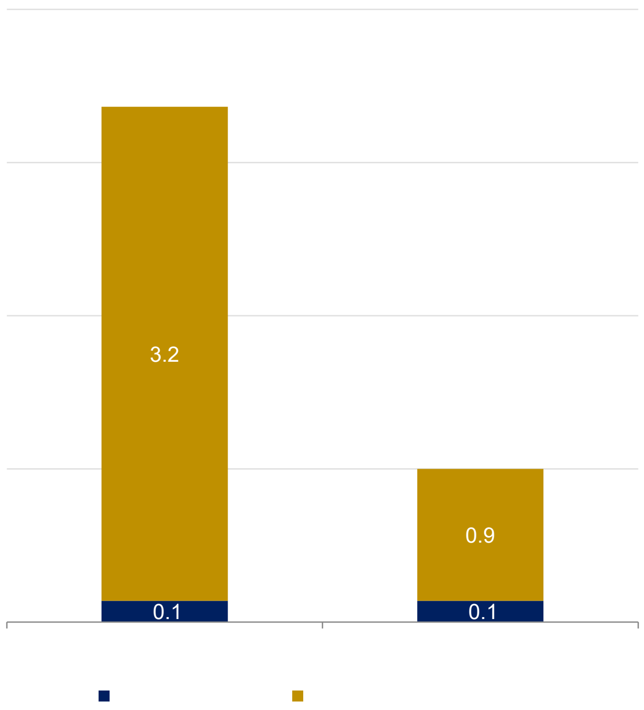
*The timing of the various stages involved in an initial public offering (IPO)*



# The allocation of shares

*The allocation process in practice*

**The objective is to identify investors who have confidence in the stock and are prepared to retain it for the long term.**




*During the allocation process, banks aim to involve these types of investors:*

- Investors willing to keep the stock for a sustained period of time
- Industry opinion leaders
- Investors who participated in the roadshow and provided valuable feedback
- Investors with strong reputation (Blackrock, State Street etc.)
- Investors who worked hard to understand the company

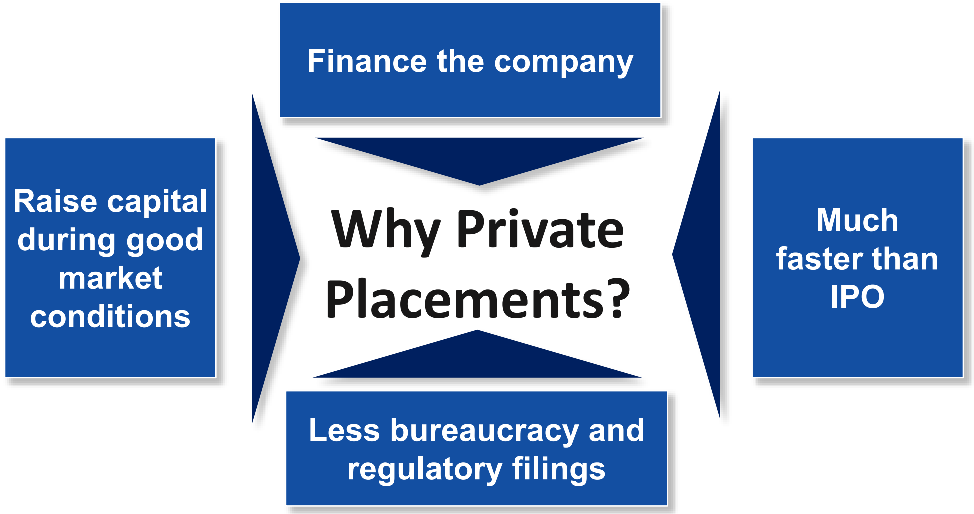
**Nevertheless, it should be remembered that the leading bank proposes an allocation and then company ownership decides whether to go through with it or not**

# SEOs and Private Placements

*Alternative ways to raise equity capital*


Seasoned Equity Offerings are similar to IPOs, but much simpler due to the following reasons:

- Documentation and filings are already prepared and submitted
- Valuation is much easier as the company is traded on the market
- Many investors are familiar with the company




Private placements are equity offerings exempt from a large part of the registration procedures

Offered to institutional investors only

# Bond offerings

*Why large companies prefer bonds over traditional bank loans as a means of financing*

Finance Growth

Diversification of financing sources

Tax deductible

Issuing a bond

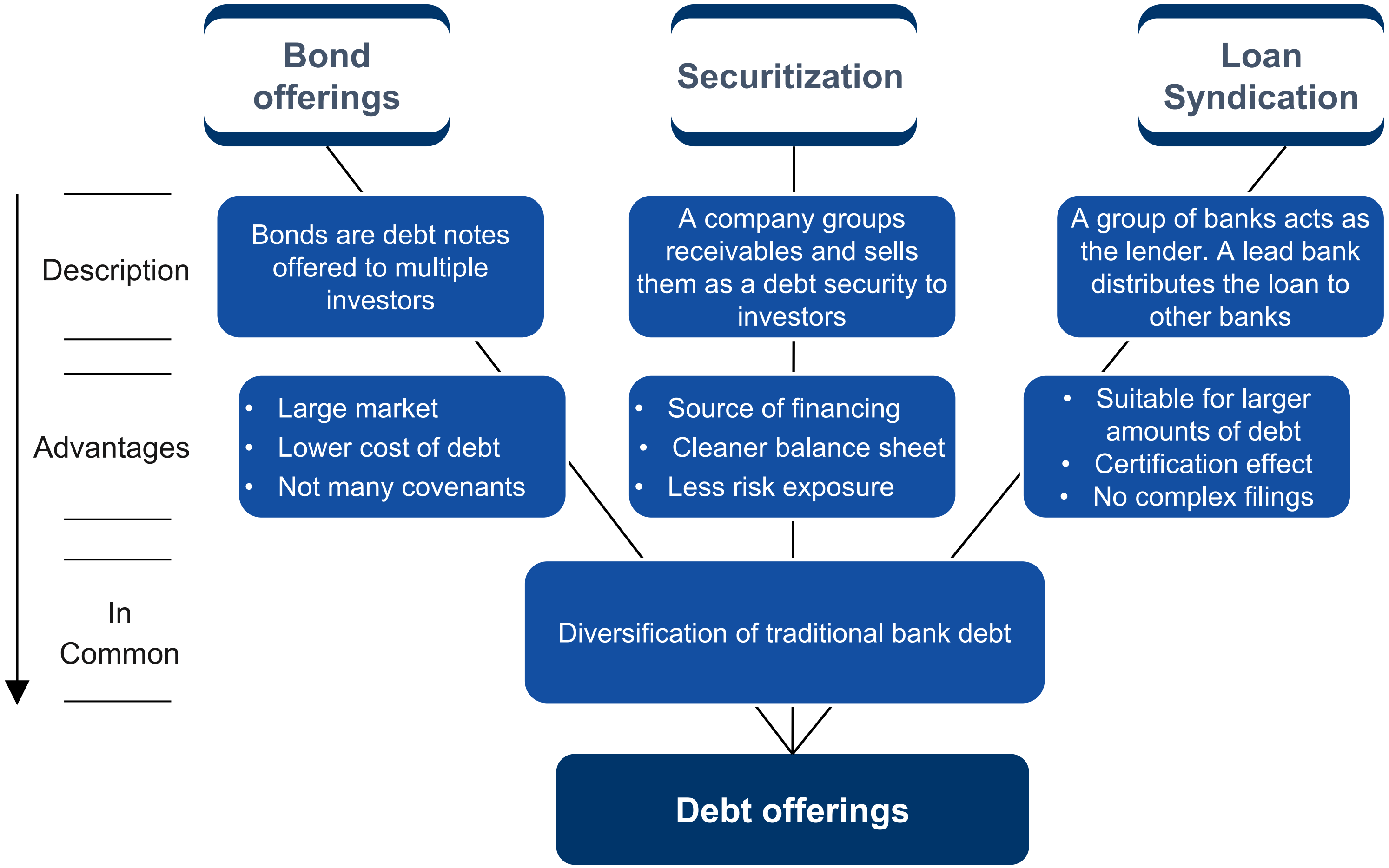
Lower cost of debt

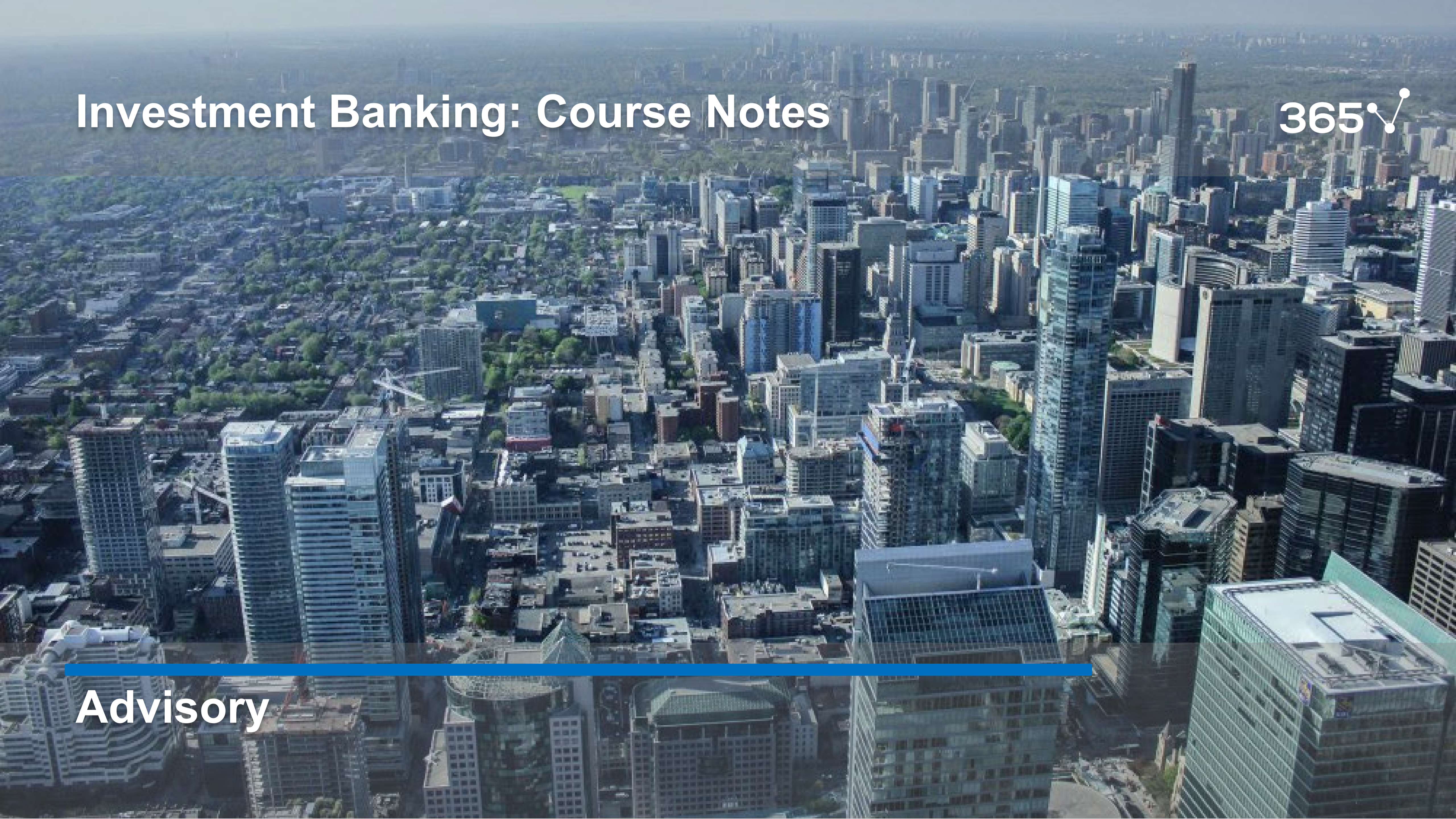
Less covenants

Signal for strong market position

# Comparison of debt offerings

***Characteristics of the types of debt offerings carried out by investment banks***



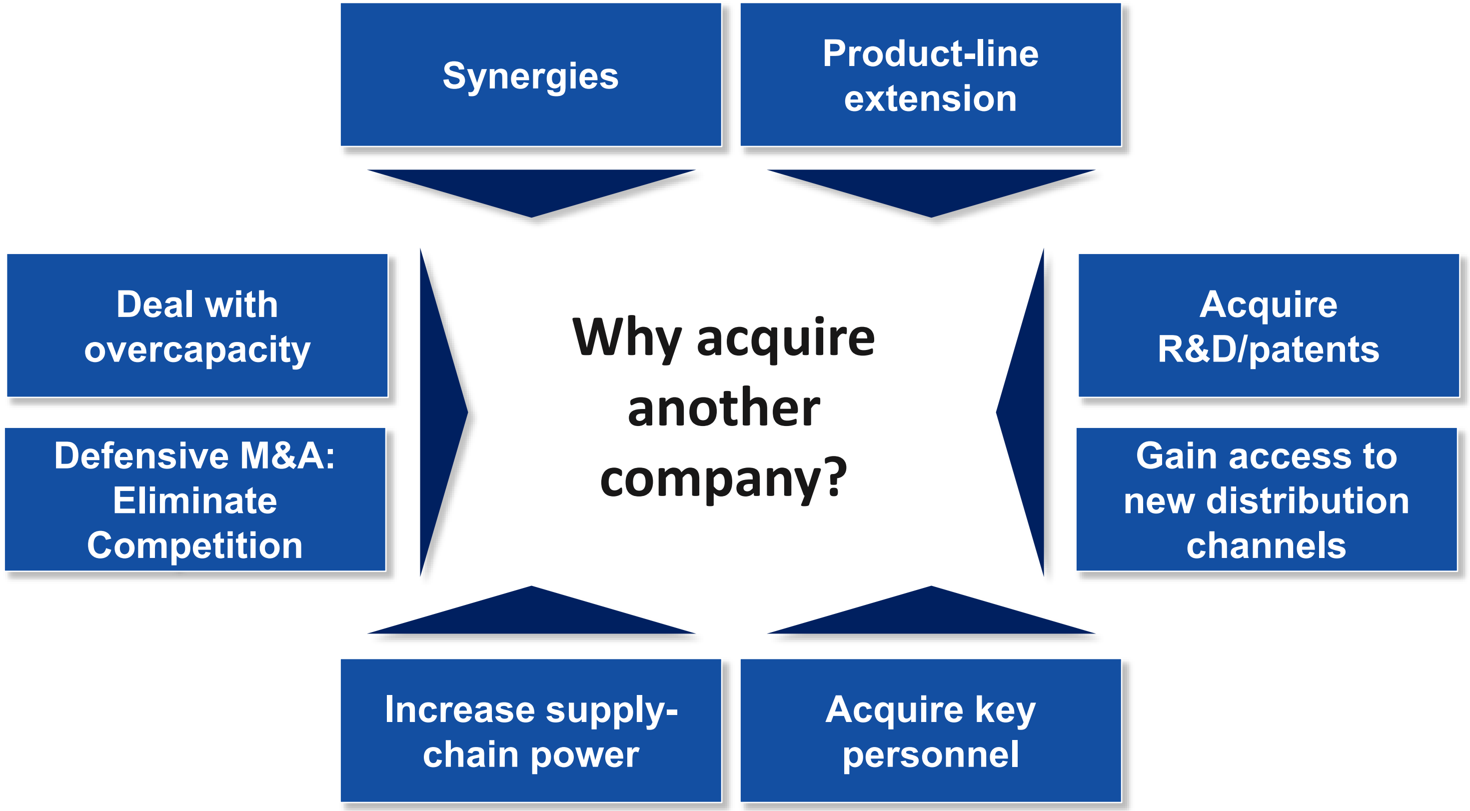


# Investment Banking: Course Notes

## Advisory

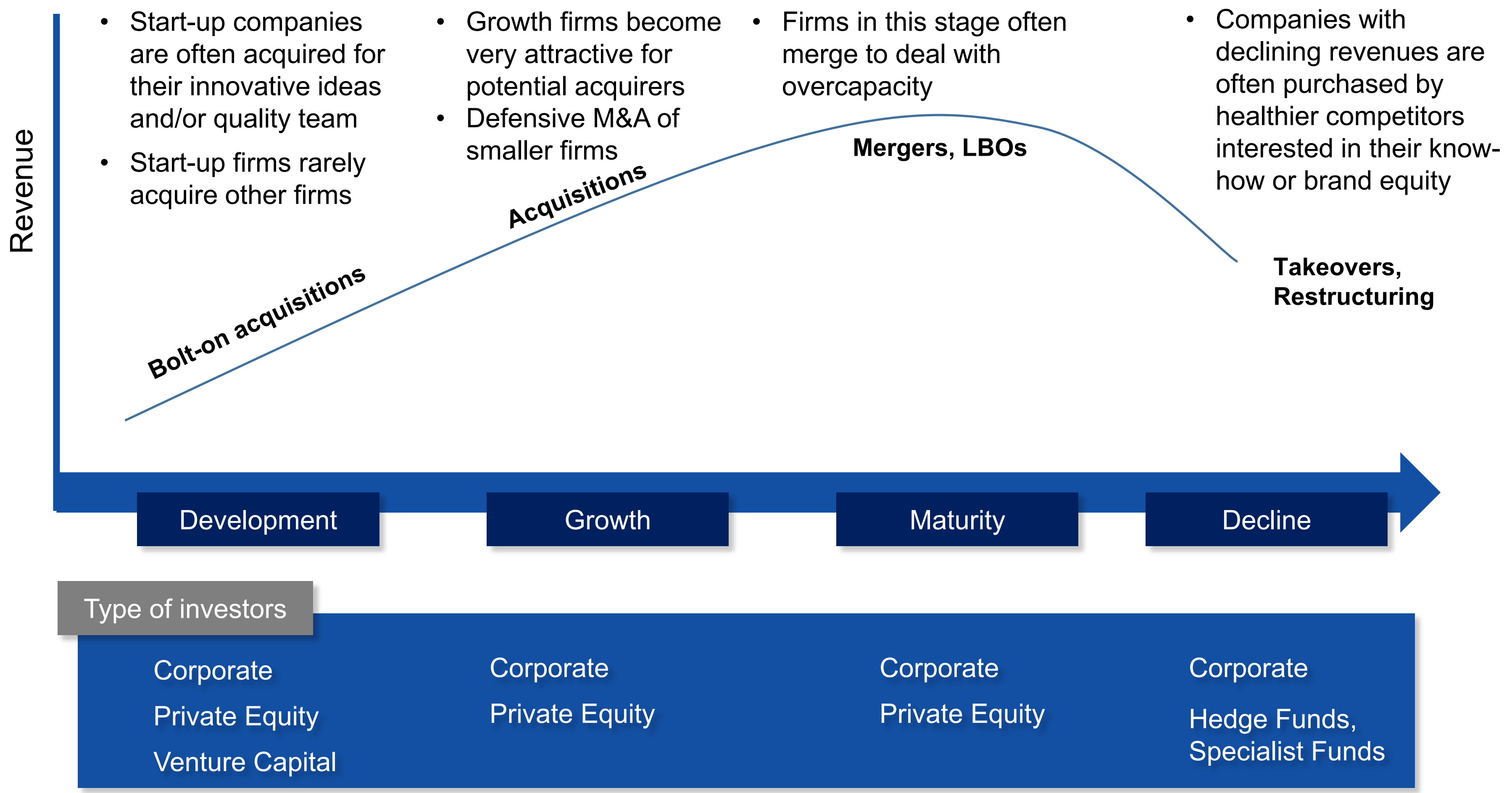
# Why acquire another company?

*The reason for M&A deals*



# Deal lifecycle and buyers

*The types of M&A deals that occur throughout a company's lifecycle*



# The process of acquiring another company

*Preparing a teaser offer*

**The deal process**

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiati on | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

| | |
|---|---|
| **Teaser** | A brief summary of the company with a short description of its business. Often does not include the company's name |

# The process of acquiring another company

*Agreeing to keep a secret*

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiation | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Confidentiality agreement**

An agreement not to distribute reserved information. The target needs to be assured that the access it gives to the bidders would not lead to a leakage of strategic information

# The process of acquiring another company

***Drafting and providing a more detailed description of the firm that is about to be sold***

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiati on | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Information Memorandum**

A document providing a description of the target's business, financials, management team, product portfolio, market positioning etc.

# The process of acquiring another company

*Communicating the rules of the transaction*

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiation | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Process Letter**

Defines the essential elements of the transaction: timing, valuation range, other conditions, due diligence access

# The process of acquiring another company

*Providing an inside look to potential acquirers*

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiati on | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Due Diligence**

The target firm provides access (limited or full) to its financial, tax and legal documentation. Often, information about the target is provided in a data room

# The process of acquiring another company

*Receiving offers from several buyers*

**The deal process**

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiation | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Binding Offers**

Offers made by the participants in an auction, indicating how much they are willing to offer for the target. As the name suggests, these offers are binding

# The process of acquiring another company

*Choosing a selected few*

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiation | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

| | |
|---|---|
| **Shortlist** | After receiving indications about a possible valuation, the target and its advisors decide which participants will be left in the auction and will receive due diligence access |

# The process of acquiring another company

*Bridging financial or operational differences*

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiation | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Negotiation**

Negotiation includes various elements such as the structure of the price, earn-out mechanisms, price adjustment terms, etc.

# The process of acquiring another company

*Approaching the shareholders of a listed firm*

## The deal process

| | Teaser | Confid. agreem. | Info Memo | Process Letter | Due diligence | Binding offers | Shortlist | Negotiation | Tender offer |
|---|---|---|---|---|---|---|---|---|---|
| Private Transaction | | ✓ | | ✓ | ✓ | | | ✓ | |
| Auction | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| Listed target | | ✓ | | ✓ | ✓ | | | ✓ | ✓ |

The process usually lasts between 2-6 months. Some auctions could even last up to an year

**Tender offer**

A tender offer is submitted to a listed firm. It is a public, open offer addressed to all stockholders, which offers to buy their shares at a specified price

# Valuation of target companies

*Different ways to value a company*

## Why is it necessary to perform a valuation of the target company?

**Find Fair Value for the Transaction**

- ✓ Find Fair Value
- ✓ Value Synergies: Corporate buyers
- ✓ Value IRR: Private equity

**Approach the right Buyers**

- ✓ Approach Bidders who could "afford" the firm

**Arrange financing**

- ✓ Define how much needs to be financed
- ✓ Justify financing in front of banks

**Discounted Cash Flows (DCF)**

**Inputs:**

- Top line forecast for 5-10 years,
- Estimated cost of capital
- Growth rate after the forecast period

**Trading Multiples**

**Inputs:**

- Comparable firms which are listed
- A measure indicating operating profitability (e.g. EBITDA)

**Transaction Multiples**

**Inputs:**

- Comparable firms, which have been subject to a transaction
- A measure indicating operating profitability (e.g. EBITDA)

Use a combination in order to triangulate results

# Payment options in M&A deals

***Different ways to pay when buying a company***

**Enterprise Value**

**Net Debt**

Financial liabilities
-
Cash

Special treatment of:
- Pension obligations
- Tax liabilities
- Litigations
- Overdue payables

**Equity**

Enterprise value
-/+
Net debt

Equity paid with:
- Cash
- Stock
- Deferral – “Vendor loans”, “Earn outs”

| **Type of payment** |  **Cash** |  **Stock** |  **Earn-out** |
|---|---|---|---|
| Advantages | ✓ Does not dilute ownership<br>✓ Crystal value for seller | ✓ Aligns the interests of new and old ownership<br>✓ No need for financing | ✓ Aligns the interests of new and old ownership<br>✓ Helps to bridge expectations |
| Disadvantages | ❖ If cost of debt is high, could be heavy<br>❖ No upside from future performance | ❖ Dilutes ownership<br>❖ Subject to valuation | ❖ Seller needs to monitor the firm post closing<br>❖ Seller depends on the Buyer’s management |

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# Financial vs. Corporate Buyers

*An important comparison between the two types of buyers in M&A deals*

| Type of Buyer | Financial Buyer | Corporate Buyer |
|---|---|---|
| Focus in the transaction | • Focus on cash flows, and capital gains | • Unlock synergies |
| Investment Horizon | • 3-5 years | • Long term |
| Type of deal | • Full Acquisition or consortia | • Full Acquisition, Merger, Joint Venture |
| Leverage in the transaction | • High | • Medium |
| Management involvement | • Following the company through Board representatives | • Integration of the Management of the two companies |
| Valuation focus | • Multiples<br>• Cash flows<br>• Cost of capital | • Synergies<br>• Growth<br>• Long term view |

# Restructuring: why and when

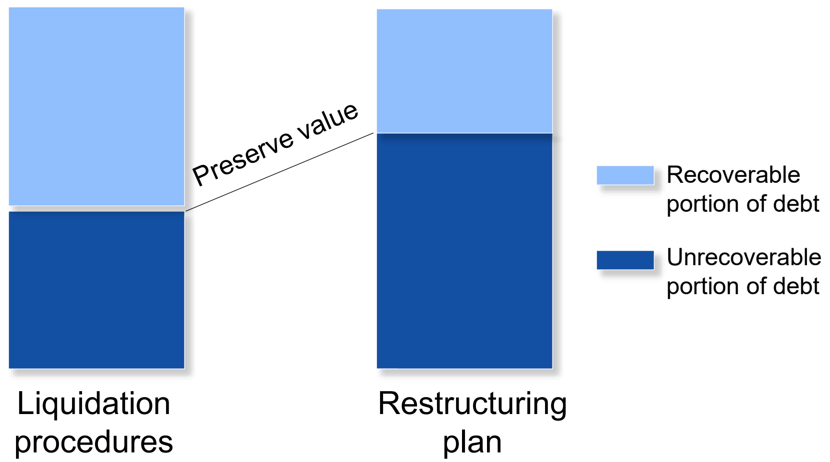
*Understanding the purpose of restructuring*

## Which are the typical reasons for corporate distress?

| | |
|---|---|
| Product obsolescence | Industry decline |
| Bad investments in non-core assets | Lack of innovation |
| Inefficiency | Bad Management |
| Bad M&A deals | Excessive leverage |

**Insufficient cash for operating activities**

## Which are the scenarios when restructuring is a viable option?




**Restructuring aims to preserve the firm as a whole and repay more debt to creditors**

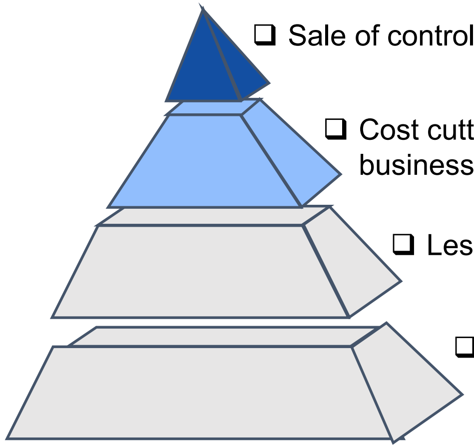
# Types of restructuring

*How restructuring can be carried out in practice*

## Asset side restructuring

**Cash Flow generation**

| **Strategic importance** | | Low | High |
|---|---|---|---|
| | High | **Optimization/ Cost cutting** | **Keep** |
| | Low | **Divest** | **Consider divesting** |



- ❑ Sale of controlled firms/brands
- ❑ Cost cutting of existing business
- ❑ Less capex
- ❑ Sell non-core assets

## Liability side restructuring

An agreement between creditors to alter the conditions under which liabilities of the company will be restructured. The assumption is that liabilities would not be repaid in their entirety

**The various options for debt restructuring are:**

- Debt refinancing
- Suspending interest payments
- Debt write-off
- Debt-equity swap
- Introduce convertible bonds

**Creditors need to assess 3 key parameters:**

- Loss given default – Liquidation
- Loss given default – Restructuring
- Probability of successful restructuring

Investment Banking: Course Notes

# Trading and Brokerage

# Trading and Brokerage

*Who is involved and what is their perspective*

| Type of institution | Focus | Time Horizon | Type of trading |
|---|---|---|---|
| Investment banks – trading desk | • Market making, profit from a bid/ask spread | Short | Brokerage |
| | • Take proprietary positions and profit from them | Short | Proprietary |
| Asset Management | • Buy securities for clients according to their preferences for portfolio allocation<br>• Provide a low price | Long | Brokerage |
| Hedge Funds | • Explore vulnerabilities in market pricing and profit from them | Short | Proprietary |

# Asset Classes

*A description of the different categories of asset classes traded by investment banks*

| Category | | Product type | Description | Typical Investors |
|---|---|---|---|---|
| Equities | 1 | **Blue chips** | Well recognized and established large firms that have stable earnings. Also known as “investment grade” companies | Mutual funds, Pension funds |
| Equities | 2 | **Other stocks** | The residual universe of stocks includes all other listed companies. Among them could be distinguished Mid and Small Cap stocks that have different risk profiles | Insurance companies, Retail Investors |
| Fixed Income | 1 | **Government bonds** | Government bonds are considered less risky. However, credit ratings vary widely among different governments. Credit Rating Agencies assess the ability of governments to repay debt | Mutual funds, Pension funds, Insurance companies |
| Fixed Income | 2 | **Corporate bonds** | Bonds issued by corporations. Credit Rating Agencies assess most corporations and express an opinion (in the form of rating). Based on this, some Mutual and Pension funds can buy only certain bonds (investment grade) | Mutual funds, Insurance companies, Retail investors |
| Other Financial Instruments | 1 | **Commodities** | Trading goods such as: coffee, corn, live cattle, rice, sugar, gold, silver, crude oil, gas, etc. | Companies, Commodity traders, Hedge Funds |
| Other Financial Instruments | 2 | **Derivative instruments** | Derivative financial instruments are many and vary significantly in their nature. Some of them are used for hedging purposes by companies (in order to reduce risk), while others are for speculative reasons. Examples are forwards, futures, options, swaps, etc. | Companies, Hedge Funds |

# Investment Banking: Course Notes

## Asset Management

# Overview

*Asset Management opportunities*

**Asset Management is a heterogeneous area. Various types of vehicles offer different risk-return investment opportunities to clients**

Traditional asset management

- Open-end mutual funds: Funds that have the ability to secure additional funding even after the fund has begun operations.
- Closed-end mutual funds: Funds that only raise capital at the start of their operations.

Alternative investments

- Real estate funds: Funds investing in real estate (commercial, residential etc.)
- Private equity: Private equity funds specialize in growth capital and LBOs
- Hedge Funds: Hedge funds aim to take advantage of market pricing errors
- Vehicles investing in other asset classes: Specialized funds investing in asset classes like art. They claim that it offers a nice diversification to the portfolio

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