**CHAPTER 19**

**INVESTMENT BANKING**

**CHAPTER OVERVIEW AND LEARNING OBJECTIVES**

* This chapter considers an important financial institution in the primary market, the investment banker. ***Investment banking*** firms operate in the direct financial market and aid in "marketing" the direct securities issued by businesses and governments. In addition, they create a secondary market for these direct securities through their brokerage activities.
* Note how the investment banking firms have diversified into a variety of activities related to bringing suppliers and users of funds together. Direct financing increased significantly in the bull financial markets of the 1980s and 1990's and the significant returns to investment banking firms attracted considerable interest from finance majors and commercial banking firms.
* As you read this chapter, note the increased competition in the investment banking markets and the general erosion (in the markets and via the courts) of the **Glass-Steagall Act**, which had kept investment and commercial banking “officially” separate for many years. The **Financial Services Modernization Act of 1999** “officially” ended the Glass-Steagall separation. Markets and their participants tend to “deregulate” years before dated laws change.
* ***Venture capital*** firms had remarkable growth during the 1980s and 1990’s. Financing higher-risk business ventures, mostly for an equity interest in the "venture," funds are provided for new technology or new applications businesses that require large amounts of high risk taking capital.

**CAREER PLANNING NOTE: BEYOND COLLEGE – IN THE “REAL WORLD”!**

We now all understand how important the first five years of life are for a child's later learning and sociability. You did not have any control over your first five years but you, and you alone, are in charge and are responsible for the next important five-year block that follows college. Your college years have been well structured and you were probably well prepared in your high school and family years to step on to college. While your college years tune your work ethic, habits, sociability, and maturity, they do little to aid you in the "big step" - the evaluation and selection of the first full-time, professional entry-level job. The experiences, training, and personal associations in the "second five years" will significantly affect your lifestyle, earnings, and the success of your professional career. While the selection of the right employer is important, the **attitude, energy,** and **commitment** you take to your new firm is probably the most important ingredient for success. From now on, ***you, and you alone****,* are responsible for what you will accomplish in your remaining college years, the selection of your career and employer, and the success of the "second five years." Start your career planning today!

**READING *THE WALL STREET JOURNAL*: WHAT’S NEW?**

The “New Securities Issues” column in the “Money & Investing” section identifies the pricing, terms, and syndicate manager for recent offerings of new securities.

**TOPIC OUTLINE AND KEY TERMS**

**I. The Relationship between Commercial & Investment Banking**

***A. Definitions***

1. Commercial banks (hereafter banks) mainly take deposits and make commercial loans, primarily being involved in the indirect financing. (See Chapter 13).

2. Investment banks, on the other hand, specialize in helping governments and businesses raise capital in the direct financial markets to fund capital expenditures.

***B. U.S. versus Other Developed Nations***

1. Until 1999, investment banks in the U. S. could not do commercial banking activities and vice versa.

2. Outside of Japan, in most other developed nations, financial institutions are allowed to do both investment and commercial banking activities. These institutions, called **Universal banks**, engage in deposit taking, making loans, brokerage activities, securities underwriting, and offering insurance services.

**II. The Structure of the Investment Banking Industry**

***A. Current and Recent Developments***

1. A large number of firms in money centers are dominated by the top ten firms. **[See Exhibit 19.1]**

2. Some investment banks have diversified to become full-service financial firms, especially in the retail services area.

***B. Early History***

1. Investment banks trace their origins to European investment houses which branched to the U.S.

2. Early U.S. commercial banks were chartered for note issue and business lending, separate from private investment banks, organized as partnerships.

3. Investment banks grew with the growth of security issuance and trading in the Civil War and later in the railroad and steel industries.

4. Commercial banks pressured for investment banking privileges from their regulators, and by the 1930s, commercial banks could provide full investment banks services.

***C. The Glass-Steagall Period and Later***

1. The decline of the stock market, the Great Depression, and widespread commercial banks failures prompted financial industry restrictions under the Glass-Steagall Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934.

2. The Glass-Steagall Act effectively separated commercial banks from investment banks.

a. Commercial banks could not underwrite (buy and resell) risky business securities.

b. Commercial banks were limited as to the risk assumed in their investment portfolio – no risky corporate securities.

c. Investment banks were prohibited from engaging in commercial banks.

d. Firms became either investment banks or commercial banks.

3. The objectives of the Glass-Steagall Act

a. Discourage speculation in financial markets.

b. Prevent conflict of interest and self-dealing.

c. Restore confidence in the safety and soundness of the banking system.

4. Relaxing the Glass-Steagall restrictions, via court decisions, was one of the major financial issues of the 1980s.

5. **The Financial Services Modernization Act of 1999** officially opened up the opportunity for cross-industry investments by commercial and investment banks.

***D. The Re-entry of Commercial Banks into Securities Business (Post 1980)***

1. In 1988, courts ruled in favor of banks to allow underwriting of securities in a limited fashion.

2. They could underwrite commercial paper, municipal revenue bonds, and securities backed by mortgage loans or consumer loans.

3. Business was to be conducted by an independent subsidiary of the bank holding company.

4. This business could not exceed 5% of the bank holding company.

5. In 1989, J. P. Morgan was allowed to underwrite and deal in corporate debt within the U.S. through its securities subsidiary, and in 1990 they were allowed to underwrite domestic corporate equity.

**III. Primary Services of an Investment Banking Firm**

***A. Bring New Securities to Market***

1. New issues are called primary issues, first issued in the primary market.

a. If the issue is the first sold to the public, it is called an **initial public offering (IPO)**. **[See Exhibit 19.2]**

b. If securities are already trading, the new issue of securities is called a **seasoned offering**.

2. Three steps of bringing a new security issue to market include:

a. ***Origination*** - design of a security contract that is acceptable to the market; prepare the state and federal Securities and Exchange Commission (SEC) registration statements and a summary prospectus, obtain a rating on the issue, obtain bond counsel, a transfer agency and a trustee, and print the securities.

b. ***Underwriting*** - the risk-bearing function in which the investment bank buys the securities at a given price and turns to the market to sell them. Syndicates are formed to reduce the inventory risk. Market price declines cut the investment bank’s margin.

c. ***Sales and distribution*** - selling quickly reduces inventory risk. Firm members of the syndicate and a wider selling group distribute the securities over a wide retail and institutional area.

3. When the investment bank guarantees the issuing firm a certain price, it is called an **underwritten** offer.

a. The risk of selling the issue at a price lower than that promised to the issuer is borne by the investment bank.

b. The difference between the price at which the issue is sold and that promised to the issuer represents the underwriting spread or the profit earned by the investment bank.

4. In a **best efforts** offer, the investment bank does not guarantee a price or that the issue will be sold.

a. The investment bank is compensated based on the number of securities sold.

b. The risk of the securities not selling or not selling at a desired price is borne by the issuing firm, not the investment bank.

c. Typically, smaller and more risky issues are sold through best efforts.

***B. Trading and Brokerage in the Secondary Market***

1. The brokerage function is to bring a buyer and seller together.

2. **Dealer function** - buying (bid) and selling (ask) from an inventory of securities owned by the seller.

3. Providing loans to customers trading on margin.

4. Dealer security inventories and customer credit are financed by bank call loans and repurchase agreements, the sale and later repurchase of securities held by the dealer. **[See Exhibit 19.4]**

5. **Full service brokerage firms** offer a wide range of financial services provided by licensed stockbrokers or account executives for commissions. Services include:

a. Storage or safekeeping of securities.

i) Securities may be left with the broker.

ii) The federal Security, Investor Protection Corporation (SIPC) insures each customer's securities up to $500,000 (replaced if lost) and cash to $100,000.

b. Execution of trades.

c. Investment research and advice.

d. Cash management service.

6. **Discount brokerage** firms offer fewer non-fee services than full-services brokers, but charge lower commissions on trades.

7. Banks may act as a broker on behalf of its customers under the Glass-Steagall Act. Banks moved into this area in the 1980s, usually as discount brokers.

8. Arbitrage activities involving the simultaneous buying between two markets is another trading activity of investment banks.

***C. Private Placements***

1. The sale of securities directly to the ultimate investor and not through a public offering.

2. The underwriting function is avoided.

3. A fee is earned for the origination/selling or uniting the supplier and user of funds.

4. A private placement may reduce the total flotation costs for a business or government.

5. The extremes of high credit quality firms and low or unknown credit quality firms use private placements.

6. SEC Rule 144A permits large institutions to trade private placements among themselves and avoid the two-year freeze in trading that was established for private placements many years ago.

***D. Mergers and Acquisitions***

1. Specialized investment banks departments provide the following services.

a. They help arrange mergers which would produce economic synergy or increased total value after merger.

b. They assist firms which have had unwanted merger offers (**hostile takeovers**).

c. They help establish the value of target firms.

2. Mergers and acquisitions have been a profitable aspect of the investment banks business.

3. Commercial banks have expanded their merger and acquisition departments.

4. Four merger-related services provided include:

a. Assist in identifying merger candidates.

b. Provide in-depth analysis (due diligence) of the target firm in preparing to price the deal.

c. Aid in negotiating, effecting, and financing the deal.

d. Provide real estate investment and brokerage.

**IV. Venture Capitalists**

***A. What do they do?***

1. Provide venture capital and management advice in return for an equity stake.

2. High-tech based firms require large amounts of capital.

3. Venture capital is usually the intermediate financing between founders' capital and the IPO.

***B. Four Categories of Venture Capital Organizations or Funding***

1. **Private independent funds** - most common, usually limited partnerships of institutional investors.

2. **Corporate subsidiaries** - provides higher risk investments for large corporations.

3. **Small Business Investment Companies** - closed-end investment trusts authorized under the SBIC Act of 1958.

4. **Individuals (*angels*)** and **entrepreneurs** may provide funds and advice for a "piece of the action."

***C. Areas of Investmen***t

1. Technology-based businesses.

2. Young manufacturing firms absorb considerable amounts of capital before sales develop their full potential.

***D. Characteristics of Venture Capital Investments***

1. Substantial control over management decisions, such as participating on the board of directors.

2. Some protections against downside risk.

3. A share of capital appreciation - convertible preferred stock is popular.

***E. Stages of Venture Capital Investments***

1. Seed financing for the “idea” stage

2. Start-up financing for product development and initial marketing.

3. Three early stages of expansio financing

a. **Seed financing** is provided at the idea stage

b. **Start-up financing** is used in product development and initial marketing.

c. **First-stage financing** – to initiate manufacturing and sales.

4. Three stages of expansion financing

a. **Second-stage financing** is for initial expansion.

b. T**hird-stage financing** to fund major expansion such as plant and equipment.

c. **Mezzanine or bridge financing** for interim financing before public offerings of securities.

***F. Three Characteristics of Venture Capital Investments***

1. Substantial control over management decisions.

2. Protection against downside risk

3. A share of capital appreciation.

***G. Required Rates of Return for Venture Capitalists***

1, Usually stated in multiples of funds invested.

2, While returns are high, so is the variability of returns **[See Exhibit 19.5]**

***H. Valuation of Venture Capital Investments***

1. Companies are compared to “comparable” public companies for valuation.

a. comparable revenues, earnings, assets.

b. benchmarking with adjustments for varied factors.

2. Multiple-scenarios valuation such as

a. optimistic

b. expected

c. pessimistic

**COMPLETION QUESTIONS**

1. \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_ issue deposits and make commercial loans, while \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_ underwrite risky securities and operate with more / less restrictions.

2. The \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_.is the major legislation, passed in \_\_\_\_\_\_\_\_, which separated commercial and investment banking.

3. The risk-bearing function of investment banking is called\_\_\_\_\_\_\_\_.

4. A \_\_\_\_\_\_\_\_ holds an inventory of securities and makes a market; a \_\_\_\_\_\_\_\_ brings buyer and seller together.

5. The federal regulatory agency that who oversees disclosure requirements and market sales trading practices is the\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_.

1. The initial public offering of stock by a company is called a(n) \_\_\_\_\_\_\_.

7. While a state or municipal government must chose an investment banker with a(n) \_\_\_\_\_\_\_\_\_\_\_\_ bid, a corporation is likely to use a(n) \_\_\_\_\_\_\_\_\_.

8. A \_\_\_\_\_\_\_\_\_\_ provides investors in new securities sufficient information to make an intelligent investment decision.

9. Buying securities with borrowed funds is called \_\_\_\_\_\_ trading.

10. The \_\_\_\_\_\_\_\_\_ officially provided that commercial banks and investment banks could own and operate in the areas prohibited by the Glass-Steagall Act.

**TRUE/FALSE QUESTIONS**

T F 1. The Banking Act of 1933, known as the Glass-Steagall Act, has effectively kept commercial banks out of the commercial lending area.

T F 2. Investment banking firms provide both financing and investment services for borrowers and lenders, respectively.

T F 3. The 40% margin rule requires the buyer/seller of a security to provide at least 60% of the funds necessary to cover the transaction, borrowing 40%.

T F 4. Venture capital firms compete with commercial banks for new business loans.

T F 5. Discount brokers offer investment advice at prices below full service security brokerage houses.

T F 6. Security brokers and dealers obtain most of their funds from customers and banks.

T F 7. Venture capital recipients are often called angels.

T F 8. Seed financing is the first stage of venture capital financing.

T F 9. Commercial banks could not own investment banking operations before the Financial Services Modernization Act of 1999.

T F 10. Brokers own the securities that help to sell; dealers do not

T F 11. Investment banking operations occur in the direct financial market.

T F 12. A best efforts sale of securities is likely to generate more revenue for the investment banker than an equivalent underwriting of securities.

T F 13. Under the Glass-Steagall Act, commercial banks were permitted to underwrite and trade Federal government securities and general obligation bonds of states and municipalities.

T F 14. Mezzanine or bridge financing is the interim financing before public offerings of securities.

T F 15. In an underwritten offer, the risk of selling the issue at a price higher than that promised to the issuer is borne by the investment bank.

**MULTIPLE-CHOICE QUESTIONS**

1. The principal risk-taking function in a new securities offering by an investment banker is

a. origination, including the design of the contract.

b. underwriting the new security issue.

c. selling and distribution of the new issue.

d. the brokerage function.

2. Commercial banks and investment banks are most competitive in the areas of

a. corporate financial services and retail brokerage.

b. mortgage and corporate financial services.

c. consumer lending and security dealer activities.

d. commercial banks are not permitted to compete under the Glass-Steagall Act.

3. Financial consulting, brokerage, private placements, and merger/acquisition services generate \_\_\_\_\_\_\_\_ for investment banks, while a \_\_\_\_\_\_\_\_ is earned in dealer and underwriting activities.

a. profits, fee.

b. fees, spread.

c. premiums, profit.

d. spread, fee.

4. \_\_\_\_\_\_\_\_\_\_\_\_ banks, in recent years, have been purchasing \_\_\_\_\_\_\_\_\_\_ banks.

a. Investment; commercial

b. Commercial; investment

c. Investment; state

d. Federal; state

5. Under-pricing by investment bankers reduces the amount of funds

a. received by investors buying the securities.

b. received by the issuing investment banker.

c. received by the issuing corporation.

d. that must be paid on the loan from the commercial bank.

6. The largest source of funds for dealers and brokers is:

a. repurchase agreements.

b. corporate bonds.

c. customer credit balances.

d. security credit from banks.

7. Venture capital investments are predominantly

a. short-term loans.

b. equity capital.

c. long-term loans.

d. repurchase agreements.

8. Selling a $20 stock for $15 in an underwriting for a client by an investment banker is called:

a. a growth opportunity for the client firm.

b. under-pricing.

c. private banking.

d. bridge financing.

9. Venture capital firms use multiple-scenario analysis and \_\_\_\_\_\_\_\_\_ to estimate the value of new businesses they finance.

a. future value analysis

b. comparable public company comparisons

c. regression analysis

d. correlation analysis

10. ***All but one of the following***is a merger and acquisition services provided by investment bankers:

a. Identifying firms that a client company might purchase.

b. Providing advice to the target company.

c. Pricing the deal.

d. real estate investment and brokerage.

11. Universal bankswere/are:

a. commercial banks operating in the U.S. prior to 1980.

b. financial institutions outside of the U.S. that can engage in deposit taking, making loans, brokerage activities, securities underwriting, and offering insurance services.

c. investment banks operating in the U.S. prior to 1980.

d. none of the above.

12. The objectives of the Glass-Steagall Act were to:

a. discourage speculation in financial markets.

b. prevent conflict of interest and self-dealing.

c. restore confidence in the safety and soundness of the commercial banks system.

d. all of the above.

13. It is called an **underwritten** offer if:

a. the risk of selling the issue at a price lower than that promised to the issuer is borne by the investment bank.

b. the difference between the price at which the issue is sold and that promised to the issuer represents the underwriting spread or the profit earned by the investment bank.

c. the investment bank guarantees the issuing firm a certain price.

d. all of the above

14. In a **best efforts** underwriting offer,

a. the investment bank is compensated based on the number of securities sold.

b. the risk of the securities not selling or not selling at a desired price is borne by the issuing firm, not the investment bank.

c. typically, the smaller and more risky issues are forced to use this type of offering.

d. all of the above are true

15. ***All but one of the following*** is true in a private placement:

a The sale of securities directly to the ultimate investor and not through a public offering.

b. The underwriting function cannot be avoided.

c. A fee is earned for the origination/selling or uniting the supplier and user of funds.

d. Private placement may reduce the total flotation costs for a business or government.

**SOLUTIONS TO COMPLETION QUESTIONS**

1. Commercial banks, investment banks

2. Glass-Steagall Act, 1933

3. underwriting

4. dealer; broker

5. Securities Exchange Commission

6. IPO

7. competitive; negotiated

8. prospectus

9. margin

10. Financial Services Modernization Act of 1999

**SOLUTIONS TO TRUE/FALSE QUESTIONS**

1. F The Glass-Steagall Act intended to keep commercial and investment banking of risky securities separate. Commercial banks have always made commercial loans but, because of changing costs in this area, want to move into the direct issuance market.

2. T investment banks are marketing financial institutions that bring sources and users of funds together by providing services to both.

3. F Margin requirements establish the proportion that a buyer/seller must provide in the purchase of securities - 40% in this case. The lender may finance up to 60%

4. F Banks and most financial institutions will not lend at the risk levels venture capitalist accept. Perhaps banks should have "just said no" to some of their commercial real estate applicants!

5. F Discount brokers operate with low overhead, provide no investment advice, and provide buy/sell services at very reasonable prices.

6. T Funds and securities are borrowed from customers' accounts and banks.

7. F The venture capitalists are the angels.

8. T Sow the seed; reap the rewards from the winners

9. T Commercial banks had effectively avoided the Glass-Steagall Act by the time the Financial Services Modernization Act was passed in 1999.

10. T Brokers bring buyer and sellers together and do not own the securities as do dealers.

11. T Investment banks specialize in helping governments and businesses raise capital in the direct financial markets to fund capital expenditures.

12. F In a best efforts arrangement, the investment bank is compensated based on the number of securities sold, thus generating a smaller revenue than in an underwritten offering.

13. T The Glass-Steagall Act permitted commercial banks to underwrite and trade only Federal government securities and general obligation bonds of states and municipalities.

14. T Mezzanine financing served as an interim financing before the firm raised external funds through an IPO.

15. T Since the investment bank has guaranteed a certain price to the issuing firm, the investment bank will not profit, and may even take a loss, if they are unable to sell the securities in the marketplace at a higher price.

**SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS**

1. b Underwriting involves the purchase of securities from a firm or government at a stated price and the risk of selling the securities in the market.

2. a In the late 1980s the investment banks and commercial banks competition has been most intense in these large volume areas.

3. b Fees are earned for services rendered; a spread is earned when an investment banks agrees to a price with security issuing firm and attempts to sell the securities in the market at a spread above the purchase price. A dealer hopes to buy (bid) and sell (ask) with a positive spread.

4. b Commercial banks have a much larger capitalization, so that they are able to purchase the investment banks firms when permitted.

5. c Under-pricing, the selling of newly issued securities under their estimated value, reduces the funds available for the issuing company.

6. c The major source of funds are balances owed customers. Increased technology and competition should reduce this account.

7. b Venture capital investment are primarily equity investments in developing companies.

8. b Selling a stock at below market price in an underwriting is called Under-pricing.

9. b Comparing the developing company with similar publicly traded companies provides a base for establishing a market value for the developing, but still private, company.

10. d Real estate investment and brokerage are not related to mergers and acquisitions.

11. b **Universal banks** are financial institutions outside of the U.S. that can engage in deposit taking, making loans, brokerage activities, securities underwriting, and offering insurance services.

12. d. The Glass-Steagall Act served to discourage speculation in financial markets, prevent conflict of interest and self-dealing, and restore confidence in the safety and soundness of the commercial banks system.

13. d All of the statements are true.

14. d All of the statements are true.

15. b In a private placement the underwriting function *is* avoided.