Evaluate an investment bank's role in private equity

Finance, Banks

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Introduction

Investment Banks provide capital requirements of a firm by performing IPOs, Bond offers, Mergers and Acquisition (M&As) and Private Equity. Investment Banks also advise corporations and other Private Equity firms on various financial transactions majorly Mergers and Acquisition, valuing IPOs and other funding structure.

In both of their roles of capital raising and financial advice, they have a crucial role to play for the success of their clients like Private Equity firms. Private Equity is the equity capital that is not publicly listed on the exchange. The major investors of Private Equity like retail and institutional investors mainly invest their capital into acquisition of an operating company. M&As through Leverage Buyout (LBO), Venture Capital, Distressed investments etc are some of the investment strategies in private equity.

Investment Banks and M&As

The majority of financial advice of Investment Banks relates to M&A.

The client company has the motives of expanding its business by acquiring another business. Some of the possible commercial reasons are –

- Product range expansion
- Increasing geographical footprints
- Vertical integration

· Strategically complementing existing products

· Preventing competitors from acquiring business in question

To give effective advice on successful M&A, investment banker needs to have an understanding of matters such as product improvement, market analysis or management of organization because they, too, will have an impact on shareholder value.

Here are the major roles that an Investment Bank plays in the transaction –

· Investment banks are specialized in particular sectors. Their specific knowledge on the industry helps them to identify the potential target firms to meet the stated objectives

· Apart from the industry knowledge, Investment Banks use their investment market acumen like correct valuations, acquisition strategy (LBO, VC, distressed investments etc), timing of striking the deal etc.

· There are many parties in an M&A deal. The role of Investment Banks is also to establish coordination between the lawyers, accountants, PR consultants and the press.

The Investment Cycle of Private Equity

The typical time frame of an acquisition of a company is approximately six months, and involves several key steps. David Solomon, in his article describes it as follows (Solomon, 2008):

1. Investment Banking Representative: the PE fund managers employ a knowledgeable Investment Bank with relevant experience in the field. An Investment Banker tries to understand the needs of the business owners, effectively communicate with the buyers and run a smooth auctions for the business.

2. Positioning the company: The Investment Banker now works closely with the company management to create an overview of the business. An investment thesis will be created that communicates the company's USPs and other opportunities to the interested parties.

3.

Contact and Communicate with the PE Funds: The Investment Bankers, by their experience, know the potential buyers and interested parties. They effectively communicate the growth story of the target company and show the promising future in conversation with the client Private Equity Fund managers. They ask the interested PE Funds to provide their own estimation of valuation of the target company before asking them to move forward in the acquisition process.

4.

Meet with interested buyers: Investment Bankers now arrange the meeting between the two parties. The target company's management gives presentation about the company to make the potential buyers further interested and make them more comfortable about their decision.

5. Due Diligence and Bidding: The Investment Bankers now help the interested buyers to start the Due Diligence process in assistance with the lawyers. Due Diligence is done to understand every minute detail of the business. After the process is over, the buyers prepare the proposal mentioning purchase price, capital structure and legal conditions.

6. Valuation: This is one of the most crucial process where Investment Bankers are involved. A range of methods are used to come up to an accurate valuation. The most commonly used factor is company's historical and future cash flows using EBITDA (Earning Before Interest, Tax, Depreciation and Amortization) as a proxy (Solomon, 2008).

7. Reinvestment: Most of the PE funds ask the sellers to reinvest about 10% to 30% in the business.

This is intended to keep the seller some " skin in the business" so that its focus is not disturbed from building the business.

8. Negotiating the Transaction: As different valuation methods yield different results, the Investment Bankers work closely with the buyers and the sellers on negotiating the final price. However, the price is not the only factor to be negotiated. The certainty and speed of closing is very crucial too. Negotiating on the indemnification terms is another area where Investment Bankers play a crucial role.

9. Final Due Diligence, Documentation and Closing: This involves careful coordination between target's management team, investment banker and the legal team to chalk out the final terms, conditions and documents.

Conclusion

The basic role of Investment Banks is to be a " middle man" in meeting two parties with complimenting interests and thereby create value for each one involved in the transaction. Lately, Investment Banks have opened their own Private Equity division. This has created conflict of interest among the traditional PE firms and the Investment Banks (MacDonald, 2005).

However, sophisticated PE Funds help the owners get unique strategic and financial assistance in building business and provide assistance to build their business and help them implement succession plans. The business owner in the process gets rewarded with significant liquidity. This very important role of a PE Fund is only possible because the effective handling of transaction between the PE Fund and the company by an experienced Investment Bank.

Discuss how investment banks value a new issue of securities (IPOs) to be placed on the market.

Introduction

The topic of IPO has been intensely researched and different scholars of Corporate Finance have described the process in their own different ways.

The best way would be to understand IPOs and the role of Investment Banks by studying the combination of approaches used by different authors. Brigham et al (1999), divided the entire process into two stages. The Stage One involves the company’s internal processes and the Stage Two involves the transaction between the company and its Investment bank and evaluates the role of Investment Banks (Brigham, 1999). Some writers give a summary of the process by focusing on decisions concerning pre-registration statements to the trading of the securities on stock exchanges (Brealy & Myers, 1999) (Grinblatt & Titman, 2002) (Weston & Copeland, 1989).

Described below are the two phases of an IPO decision making process:

Phase-I IPO Decisions:

Following are the decision variables that a company internally considers before issuing the IPO –

1. Amount to be raised: The fist decision to consider is the amount of capital required by the company.

2. Type of Securities to use: Once the amount is decided, the company considers all type of securities like shares, bonds and other innovative securities like exotic securities.

3. Competitive Bids versus a Negotiated Deal: A company can see a block of securities to the highest bidder. Alternatively, it can negotiate a deal with an Investment Banker.

If the company has a well established name, it generally goes with competitive bids while negotiated deal is generally the option for smaller firms not known to the investment bankers.

4. Selection of an Investment Banker: This is a very critical step as the choice of an Investment Banker can also affect the success of IPO process. The problems faced by firms are intensive as there is no model for them to rely on to choose the right investment banker to make the IPO successful (Manaster & Carter, 1990). The reputed investment banks target the established firms for IPO while the new ones are good at speculative issues and new companies going public.

Phase II IPO Decisions

The inputs of the selected Investment Bankers are now included in the Phase II Decisions.

Following are the components of the Phase II decision process:

1. Re-evaluating the initial decisions: Here the firm and the Investment Banker re-evaluate some of the decisions like the amount to be raised and type of securities to be used. This is done to ensure the successful completion of IPO process.

2. Filing of Registration: The investment banker now collects all the relevant information from the company and files the application to the Securities Exchange Commission of the country and stock exchange if it wants its shares to be traded publically.

3. Pricing of the Security: The investment bankers use their research and experience to price the security. The pricing depends upon host of issues. The important ones are the risk profile of the company, market appetite to accommodate the issue, reputation of the investment banker etc. The pricing issue is one of the main sources of conflict between the company and the investment banker (Weston & Copeland, 1989) (Brigham, 1999) (Grinblatt & Titman, 2002).

The most commonly used method is DCF method. DDM tends to underestimate value, while DFCF produces unbiased value estimates (Deloof, De Maeseneire, & Inghelbrecht, 2009). When using multiples, investment banks rely mostly on future earnings and cash flows. Multiples based on post-IPO forecasted earnings and cash flows result in more accurate valuations (Deloof, De Maeseneire, & Inghelbrecht, 2009).

4.

Forming the Underwriting Syndicate: Sometimes, it may not be possible for the investment banker to underwrite the whole issue and may have to form an underwriting syndicate. This ensures diversification of the risk and nationwide distribution.

5. Forming the Selling Group: It is formed to facilitate the distribution of the issue. The control of the selling group rests with the investment banker.

6.

Offering and Sale: Once the regulatory authorities approve the securities, the company goes for publicity campaigns and the important dates are mention in the advertisements to avoid unfavorable circumstances.

How Investment Bankers value the IPO

There are a number of methods available for valuing IPOs. Some of the most common methods are dividend discount model (DDM), discounted free cash flow method (DFCF) and industry multiples. Berkman, Bradbury and Ferguson (2000), value 45 newly listed firms in New Zealand and conclude that the best discounted cash flow and P/E valuations have similar accuracy (Berkman, Bradbury, & Ferguson, 2000).

The valuation methods used by the investment bankers depend on IPO firm characteristics, aggregate stock market returns and stock market volatility (Roosenboom, 2007). There are a lot of authors that argue that multi period valuation models based of Discounted Cash Flows are better than single period multiple valuation models which may result in less accurate valuations (Penman, 2007) (Palepu, Healy, & Bernard, 2000). However, professional investors and financial analyst's valuation methods stand in contrast to the claims made by these authors. The strongest and most empirical finding is the use of P/E ratio and relatively lesser use of DCF, technical analysis and beta analysis (Govindarajan, 1980) (Arnold & Moizer, 1984).

As we had discussed earlier, there are industry specialist investment bankers. Hence, different industry investment bankers use different valuation models. P/E multiple is the most commonly used model in the services, industrial and consumer goods sector (Barker, 1999). The dividend yield model is commonly used in financial sector and utilities while stable sectors like Pharmaceuticals attract comparative valuations.

Conclusion

While it is inherently impossible to find out the exact, accurate and true value of a firm, there are a lot of studies done to examine the accuracy of valuation models. Different models yield different values.

Investment Bankers, therefore use more than one methods of valuation, out of which DCF method is most popular, to find out the inherent value of the IPO for their clients (Deloof, De Maeseneire, & Inghelbrecht, 2009). Investment banks consider profitability, growth and risk as important factors for the accuracy of comparables model. Interviews with Investment Bankers suggest that underwriters consciously underprice IPOs by further discounting the DCF value estimates (Deloof, De Maeseneire, & Inghelbrecht, 2009). The success of an IPO, however, depends not only on the valuation estimates of the firm by the investment banker, but also upon the other processes like amount selection, underwriting, selling groups, distribution, publicity campaigns etc discussed in the early part of this paper.

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