MN50412: Investment banking

Revision Lecture:

May 6th 2010

Exam Structure

- Section A: Numerical: answer 1 out of 2 questions: each question worth 30 marks
- Section B: answer 2 out of 3 essays: each essay worth 35 marks.

Skills:

- Numerical: class exercises
- Conceptual: lectures, articles

Conceptual topics

- IBs and IPOs
- IBs and bond issues (in particular CD)
- IBs and Mergers and acquisitions
- IBs and derivatives
- IBs and asset management

IBs and IPOs

- Why firms go public.
- IB process in IPOs.
- IPO underpricing: “cash left on the table”
- Winner’s curse hypothesis
- Lawsuit hypothesis
- Signalling theory
- Fads/herding
- Ownership dispersion hypothesis

Why firms go public

- Need to expand/lack of other financing choices
- Too much debt: firm optimising capital structure
- Allows current investors to cash out (founders demand liquidity)
- Firms get valued by the market
- Future source of capital: SEOs.
- Diversification/risk-sharing
- Increased transparency of firm actions
- Firm can offer incentive contracts: stock options

Disadvatages of going public

- Costly, time-consuming process
- May not be appropriate for all firms
- Ownership is diluted/founder loses control
- Competitors benefit from transparency
- Regulators have increased authority

Direct Financial Costs

- Prospectus filing costs
- IB involvement: large transaction costs:
- => IB fees
- => IPO underpricing.

IPO process

- Reputation, expertise, credibility of the IB important.
- Follow-on products important, such as research coverage
- Prior relationships between firm owners and IBs

Offering method

- Firm commitment
- Best efforts
- Rights offering
- Academic papers discussing these methods

Valuation of firm

- IB values firm using:
- DCF
- Compare with a peer group using multiples
- Offer range
- Due diligence

Why involve an IB?

- Reduced asymmetry => better market price
- IB reputation, credibility in a repeated-game setting.
- Fees and underpricing.

Syndicates in IPOs

- Risk: offering price too high: not able to sell all of the issue
- Firm commitment contract increase risk to IB
- Syndicates spread risk
- Information production
- Certification, underwriter reputation, and analyst coverage.

Added Value of Syndicates

- Information production: geographical spread
- Moral hazard problem
- Syndicates may induce more effort (rotation of lead underwriter)

Underpricing of IPOs

- Asymmetric information/signalling
- Winner's curse hypothesis
- Lawsuit hypothesis
- Fads in the early aftermarket
- Herding/cascades
- Ownership dispersion hypothesis

IBs and Convertible bonds

- Why firms issue convertible bonds
- Irrelevance story =>
- Miller-Modigliani framework
- Some managers think, CD cheap due to a) low coupon rate, price premium, but….
- Expensive lunch versus cheap lunch
- So why do firms issue CD?

Motives for issuing CD

- “Equity through the back door”
- Signalling models (eg Stein).
- Agency problems (eg Mayers).
- Reducing risk-shifting

IB involvement in CD

- "Cost of Financial Distress, Delayed calls of covertible bonds,and the role of the investment banks" by Jaffee and Shleifer,
- • "Do Investment banks' relationships with investors impact pricing/ The case of convertible bond issues." Henderson and Tookes

Cost of Financial Distress, Delayed calls of covertible bonds,and the role of the investment banks

- In a Frictionless market with perfect information,
- shareholder-wealth maximising firm should force conversion of CD as soon as it is in the money
- Evidence of delays in calling CDs
- Costs to shareholders of a failed conversion => financial distress
- Self-fulfilling bad outcome
- IBs can mitigate by underwriting

"Do Investment banks' relationships with investors impact pricing/ The case of convertible bond issues.“

- the role of search frictions in convertible bond pricing.
- two channels through which search frictions might impact initial pricing:
- the ease of attracting initial investors and expected after-market liquidity.
- negative relationships between at-issue discounts and both types of frictions.
- search frictions play a meaningful role in pricing
- intermediaries can add value through repeated interactions with investors.
- This is in contrast to conflict of interest hypotheses, in which banks use underpricing to reward favored clients.

IBs and M and A

- "The Role of Investment Banks in Acquisitions" by Servaes and Zenner Review of Financial Studies 1996
- "Investment Banks and Market Share... " by Raghavendra Rau, Journal of Financial Economics 2000
- "Investment Banking Relationships and Merger Fees" by Saunders and Srinivasan 2001
- "Choice of Investment Banker and Shareholders wealth .... " by Bowers and Miller Financial Management 1990
- "Investment bank reputation and shareholder wealth... " by Schiereck et al Research in International Business and Finance 2009

Investment bank reputation and shareholder wealth

- Superior deal hypothesis: higher reputation IBS => higher overall gains
- Bargaining advantage hypothesis
- => higher reputation IB => larger share of the gains