I TRUSTED ADVISEMENT I

The Value of an Investment Banker

How to choose wisely

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Investment banking evolved from the 18th-century European merchant banking system which was dedicated to funding the emergence of global trade by assembling capital from wealthy families. Based on the necessity of raising additional capital to fund trade expansion, investment banks were created to raise capital from an expanding investor base. From this genesis, investment banks have maintained a critical role in a development of a vibrant capital market, and provide a plethora of other offerings such as mergers & acquisitions advisement. This article will focus on the value of an investment bank, and moreover, how to choose an investment banker.

Raison D'etre

Virtually all companies retain an investment bank to provide advisory and transaction execution services because the investment banker represents a portal to the sentiment of the marketplace in regard to the former, and performs critical functions that produce a more affirmative result in regard to the latter. A few companies decide to "go-it-alone" based on: 1) a developed counterparty relationship, 2) a lacking understanding of the value proposition, and 3) sometimes hubris. Nevertheless, investment bankers will always produce value for their clients substantially beyond their cost. A few of the key sources of value are noted below.

Core Advisory Value

While investment banks provide companies with advisement related to expected and realized transaction event outcomes, and other matters, the "best-value" is provided when investment bankers approach a company agnostically for purposes of advising as to the optimal alternative given a company's setting and outlook. This may entail advising against a certain type of transaction, e.g., the premature sale of equity. An unbiased approach is aligned with serving as almost a fiduciary "partner," vs. a hired-gun functionary, and placing the best interests of the company and its ownership before the desire to execute an immediate transaction. However, this qualitative orientation requires investment bankers to have "strategic" capabilities exceeding normal boundaries.

Core Transaction Value

Competitive Dynamic. First, the mere retention of an investment banker signifies a formal competitive process will be undertaken. Not surprisingly, counterparties are not fond of auction processes because the competitive dynamic holds their feet-to-the-fire in regard to offering full value, vs. advantaging a party via a private negotiation (a counterparty's "dream"). To wit, many private equity firms and sources of debt maintain extensive direct solicitation programs to preclude a competitive dynamic and achieve their dream scenario.

Material Preparation. Investment bankers will know how to prepare the most useful information for counterparties related to the earnings quality and growth profile. For example, a financial projection that is reasonable and reconcilable will afford greater validity. Also, while large investment banks tend to prefer PowerPoint style information disclosures, my preference is to provide more comprehensive materials to reduce uncertainties so diligence is more confirmatory than investigative, and more precise offer indications can be received earlier.

Counterparty Selection. In regard to strategic counterparties, an investment banker will provide an architectural capability through the identification of not only obvious "core" candidates, but also those parties possessing a synergistic basis to pursue an adjacency (horizontal integration) and related-diversification (vertical integration). In regard to financial counterparties, the investment banker's task entails aligning the defined counterparty investment criteria to the client and its objective.

Soft Skills. Investment bankers typically have excellent negotiation skills although few have experienced the negotiation program at Harvard or a University of Chicago negotiation workshop. These skills are complemented by: 1) enriching experience enabling the anticipation of a progression of positions and counter-positions, and the engineering of optimal BATNA's, 2) an understanding how to make earnings quality and growth arguments to impact valuation and consideration exchange, and 3) the ability to establish integrity with counterparties.

Client Insulation. An indirect form of value is insulating a client from regular contact with the counterparty. A goal of counterparties is to develop an affirmative relationship with a company in the hope of reaching a certain tipping-point beyond which the company becomes enrolled in getting the deal done, and thereafter, possibly materially compromising on outstanding terms. Further, without representation a company can become more susceptible to "transaction fatigue," and cross-lines to its detriment. Lastly, an investment banker will enable the company to preserve a positive relationship with its counterparty on a post-transaction basis by gladly wearing the "black hat."

Choosing Wisely

Given the value of an investment banker, the question then becomes how, or on what basis should an investment banker be chosen? Hopefully the following will provide some guidance.

The Firm vs. The Individual. At first glance, one might think it might be best to retain the largest investment bank or the one that does the most transactions. While there might be a concern about being one of many clients, a high-profile firm might afford an implied warranty about the capability. However, what you are really hiring is not a firm, but in reality, the person who walks through the door. Thus, the basis of a decision should be dedicated to evaluating the senior banker, whether coming from a large or small firm.

Key Attributes. The paramount attribute is a record of success based on a depth of experience, and many investment bankers will be able to present such a record. So, the basis of differentiation may entail difficult to assess professional capabilities such as: 1) judgment skills, 2) negotiating skills, 3) listening skills, 4) explanation clarity, 5) enrollment and nurturing skills, 6) demonstrated creativity, 7) tenacity and passion, 8) interrelated knowledge, 9) the person's "why," and last, but not least, 10) integrity.

Some Red Flags. There are some things that may be expressed by an investment banker which should give pause. Declarations regarding: 1) "knowing parties that would be interested" is an antiquated argument given the extreme efficiency of counterparty identifying databases, 2) "the marketplace will determine the value" in lieu of providing valuation guidance is an abdication of responsibility, 3) the ability to "achieve the highest value" or representing a very high expected value without a detailed analytical reconciliation is hollow, and 4) "being a tough negotiator" belies the best-practices related to optimizing negotiations.

Common Conundrums

Industry Specialization: The pro argument is an immediate understanding of the nuances and players, and the con is the sentiment that existing industry relationships will not be stressed for the client. **Transaction Specialization:** The pro is a depth of redundant experience, and the con is a less than optimal understanding of the dimensions related to the "other side of the transaction." **Transaction Teams:** The pro argument is theoretically more man-hours and wider coverage, and the con is a division of labor dedicated to limiting the senior banker engagement. **Fee Levels:** The pro is investment bankers always produce substantial value in excess of their cost and fees are subject to negotiation, and the con is sometimes sticker-shock.

Methodology & Questions

Identify and execute NDA's with, and provide information to a set of investment banks requesting: 1) a response to a set of questions, 2) a reference list, 3) samples of work, and 4) an engagement agreement, and thereafter, 5) a meeting. The quality of the response will be a measure, along with witnessing the investment banker exercise soft skills, e.g., performing an enrollment process (on you). During the meeting, remember, you can never ask "why" or "how come" too much. Here are some headline questions:

- What is the basis of the optimal timing and form of a transaction?
- What will be the configuration of the counterparty group?
- What are the value drivers and detractors of my business?
- What is a reasonable valuation of my company?
- What are the keys to maximizing the value and outcome?
- What direct or indirect experience have you had in my industry?
- What are examples of good judgment you have made for your clients?
- What are examples of unsuccessful outcomes you have experienced?
- What you do consider to be your negotiating style or approach?
- Why do you do what you do?

Summary Statement

It is hoped you will regularly contact an investment banker to seek advisement, and retain an investment banker to execute a transaction event. The selection of an investment banker will be based on a clinical review, but more so and ultimately, predicated on your instincts about integrity because trust is the best basis of choosing wisely.