Preface

From a historical point of view, the main activity of investment banks is what today we call security underwriting. Investment banks buy securities, such as bonds and stocks, from an issuer and then sell them to the final investors. In the eighteenth century, the main securities were bonds issued by governments. The way these bonds were priced and placed is extraordinarily similar to the system that investment banks still use nowadays. When a government wanted to issue new bonds, it negotiated with a few prominent “middlemen” (today we would call them investment bankers). The middlemen agreed to take a fraction of the bonds: they accepted to do so only after having canvassed a list of people they could rely upon. The people on the list were the final investors. The middlemen negotiated with the government even after the issuance. Indeed, in those days governments often changed unilaterally the bond conditions and being on the list of an important middleman could make the difference. On the other hand, middlemen with larger lists were considered to be in a better bargaining position. This game was repeated over time, and hence, reputation mattered. For the middlemen, being trusted by both the investors on the list and by the issuing governments was crucial. In case of problems with a bond, investors would have blamed the middlemen, who naturally became advisors in distressed situations. For example, in the nineteenth century, the accumulation of capital in America was not sufficient to finance the increasing investments in railroads and other infrastructure. The nascent investment banking industry imported capital from the old Europe through the issuance of bonds. In 1842, a spectacular crash in the price of cotton reduced eight American states to default on their bonds. A firm and immediate reaction by investment bankers followed. All the attempts by any American state (even the non-defaulting ones) and by the Federal Government to raise new capital were frustrated. James de Rothschild said to the representatives of the Federal Government: “You may tell your government that you have seen the man who is at the head of the financiers of Europe, and that he has told you that they cannot borrow a dollar, not a dollar” (Reported in "Investment Banking. Institutions, Politics, and Law" by A.D. Morrison and W.J. Wilhelm, 2007, Oxford University Press).
investment banking industry orchestrated the recovery through a lobbying activity that convinced the defaulting states to meet their obligations. This was a clear signal that the quality of a security was also related to the investment bankers that placed it. Many investment banks did not survive the crisis stemmed from the crash in the cotton market, but a number of newcomers emerged. Few years later, several railroad companies defaulted on their bonds, and investment banks were again engaged in reorganizations. Some of the bondholders ended up converting their claims into equity. They mostly exerted their voting rights through a voting trust created and coordinated by investment bankers, who thus indirectly controlled the company. The words of John Pierpont Morgan to the owner of a distressed railroad company are enlightening: “Your railroad? Your railroad belongs to my clients!” (Morrison and Wilhelm, 2007). It was the rise of the advisory services, the natural evolution from security underwriting. Since then, a number of crises hit the financial system, reshaping the investment banking industry.

Today investment banking comprises a rather heterogeneous and complex set of activities, including underwriting and advisory services, trading and brokerage, and asset management. Nonetheless, underwriting and advisory activities are still considered the traditional or “core” investment banking functions. With underwriting services, an investment bank helps firms to raise funds by issuing securities in the financial markets. These services are labeled “underwriting” because investment banks actually purchase securities from the issuer and then resell them to the market, like the middlemen in the eighteenth century. Investment banks also provide advisory services to help their client firms with mergers and acquisitions and corporate restructuring in general, somehow similarly to the function performed with the reorganization of distressed railroads in the nineteenth century.

This book aims at providing an overview of these traditional investment banking activities. It basically covers equity offerings (IPOs, SEOs, rights issues), debt offerings (bond issues and syndicated loans), and advisory on M&As, LBOs, and other restructuring transactions. I started to use these notes in the Investment Banking course I lecture in the M.Sc. in Finance at Università Bocconi. Three main features of this guide should be pinpointed. First, it is not a corporate finance book: the focus here is on the role of the investment banks in the different transactions. Although the technical aspects of each investment banking deal are covered, all the corporate finance concepts (including company valuation) are considered pre-requisites. Second, this book blends practical tools and academic research. However, I decided to include research findings only if they have direct implications in real-life situations. Finally, this guide is intended to be used in graduate courses on investment banking to complement a set of case studies. Therefore, it should be considered as a quick reference guide, rather than a comprehensive handbook on investment banking.

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Suggestions and comments on this first edition will be greatly appreciated.

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