

# **The International Investment Banking Industry**



**The Swiss Banking Institute**

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# Presented By

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# What Is Investment Banking?

- **Can Be Defined To Encompass Many Activities**
- **Definition Usually Involves At Least:**
  - Underwriting And Distributing New Security Issues
  - Offering Brokerage Services To Public & Institutional Investors
  - Providing Financial Advice To Corporate Clients, Especially On Security Issues, M&A Deals
  - Providing Financial Research To Investors, Corporate Customers
  - Market-Making In Particular Securities

# De Facto Definition OF IB Today Is Much Broader

- **Many IB Firms Now Offer Additional Services:**
  - Providing Fee-Based Asset Management Services
  - Proprietary Trading For Customers, Own Account
  - Merchant Banking, Venture Capital Investing
  - Providing Bridge Loans For M&A, New Financing
  - Arranging & Funding Syndicated Loans
  - Foreign Exchange Trading & Hedging
  - Arranging Swaps, Other Risk Management Tools
  - Providing Private Banking Services

# Risks Assumed By Financial Intermediaries

- **Financial Intermediaries Defined By Type Of Risk They Assume:**
  - Commercial Banks Assume Credit Risk
  - Insurance Companies Assume Event Risk
  - Investment Bankers Assume Market Risk
- **Course Will Focus On IB's Classic Corporate Finance Role Of Bearing Market Risk:**
  - Specifically, Underwriting & Selling Securities
  - Other Roles Important, But Not Unique To IB

# Key Laws Governing Investment Banking Practices

- **Most Key Rules Of The Game Set By Depression-Era US Laws:**
  - Securities Act of 1933 Mandated Disclosure Of All Relevant Information In Security Issues
  - Glass-Steagall Act of 1933 (Not Really Act Itself) Separated Investment & Commercial Banking
  - Securities & Exchange Act Of 1934 Set Up SEC, Established Financing & Governance Procedures
- **Though Frequently Amended, All Are Still Law**
  - Glass-Steagall Weakened, But Not Repealed

# **International Rules & Treaties Much Less Stringent**

- **European Countries Generally Less Restrictive**
  - Germany Allows Universal Banking
  - Other Countries Allow Almost As Much Freedom
  - UK The Center Of International Finance & British Commercial Law Is The De Facto Standard
- **Japan Saddled With Article 65 By Occupation**
- **Eurobond, Eurocurrency Markets Unregulated**
- **UK Big Bang Of 1986 Solidified London's Position**
- **Basle Accords Of 1988 Set Capital Standards For International Banks**

# **Course Will Cover Ten Key Topics**

- **Patterns in Worldwide Securities Issuance During The 1990s**
- **The Strengths, Weaknesses, And Strategies Of The Key Players In The IB Industry**
- **Capital Markets And The Three Basic Models Of Corporate Finance**
- **Investment Banking Practices In International Debt Security Markets (Eurobonds, MTN, etc)**
- **Bank-Based IB Products (Syndicated Loans And Project Finance)**

# **Course Will Cover Ten Key Topics (Cont.)**

- **International Stock Markets & Privatization's Critical Role In Their Development**
- **The Euro's Likely Impact On Global Capital Markets**
- **The Increasing Importance of Mergers & Acquisitions To The Global IB Industry**
- **American Investment Banking Characteristics And Industry Practices**
- **Venture Capital And Initial Public Offerings In The United States**

# **Course Will Conclude With A Summary of Key IB Challenges**

- **The Impact Of Information Technology & Telecommunications On Investment Banking**
- **Deregulation, Privatization, and The Growth of Private Infrastructure Financing**
- **The Rise of Funded Pension Systems**
- **Dueling Currencies: Dollarization and The Growth of Euro Zone Capital Markets**
- **The Continuing Rise Of The Bulge Bracket**
- **Are Financial Groups The Wave Of The Future?**

# **Topic 1:**

## **Patterns In Worldwide Securities Issuance During The 1990s**

# **Trends In Investment Banking Worldwide**

- **The Revolutionary 1990s: An Incredible Decade**
- **\$15 Trillion In Total Security Issuance**
- **\$10 Trillion In Mergers & Acquisitions**
- **A Major New Currency Is Born**
- **Privatization & The Growth Of Stock Markets**
- **Capital Markets Vs Banks In Corporate Finance**
- **The Evolution Of A Truly Global Industry**
- **US Industry Practices Spreading Worldwide**
- **The Rise of Funded Pension Programs**

# **Details Of Worldwide Securities Issuance During the 1990s**

- **Over \$2.5 Trillion Securities Issued On Public Capital Markets Worldwide During 1998**
- **Almost \$0.5 Trillion More In Private Placements**
- **Over \$15 Trillion Total Public Offers This Decade**
- **Each Year, US Issuers Account For Two-Thirds Of Total Public Issue Volume, Most Private Issues**
- **Debt Securities Account For Over Three-Fourths Of Total Every Year**
- **New Common Stock Issues Play Small Role In Corporate Finance Everywhere, Even US**

# Number And Value Of Worldwide Security Issues In 1998

<u>Security Type</u>	<u># Of Offerings</u>	<u>Value \$US Bn</u>
Total Debt & Equity	17,906	\$2,532
International Debt	4,682	\$888
Eurobonds	2,735	\$606
Yankee Bonds	1,704	\$241
International Common Stock	575	\$74

# Number And Value Of Public Security Offerings By US Issuers In 1998

<u>Security Type</u>	<u># Of Offerings</u>	<u>Value \$US Bn</u>
All Domestic Issues	14,395	\$1,820
Capital-Raising Issues	12,121	\$1,228
Investment-Grade Debt	10,850	\$1,065
Corporate Debt	6,406	\$654
Collateralized Securities	2,151	\$561

## **Number And Value Of Public Security Offerings By US Issuers (Continued)**

<b><u>Security Type</u></b>	<b><u># Of Offerings</u></b>	<b><u>Value \$US Bn</u></b>
<b>Tax-Exempt Municipal Bonds</b>	<b>13,469</b>	<b>\$265</b>
<b>Common Stock</b>	<b>240</b>	<b>\$108</b>
<b>Initial Public Offerings</b>	<b>372</b>	<b>\$37</b>
<b>Preferred Stock</b>	<b>238</b>	<b>\$42</b>
<b>Convertible Debt &amp; Preferred Stock</b>	<b>167</b>	<b>\$33</b>

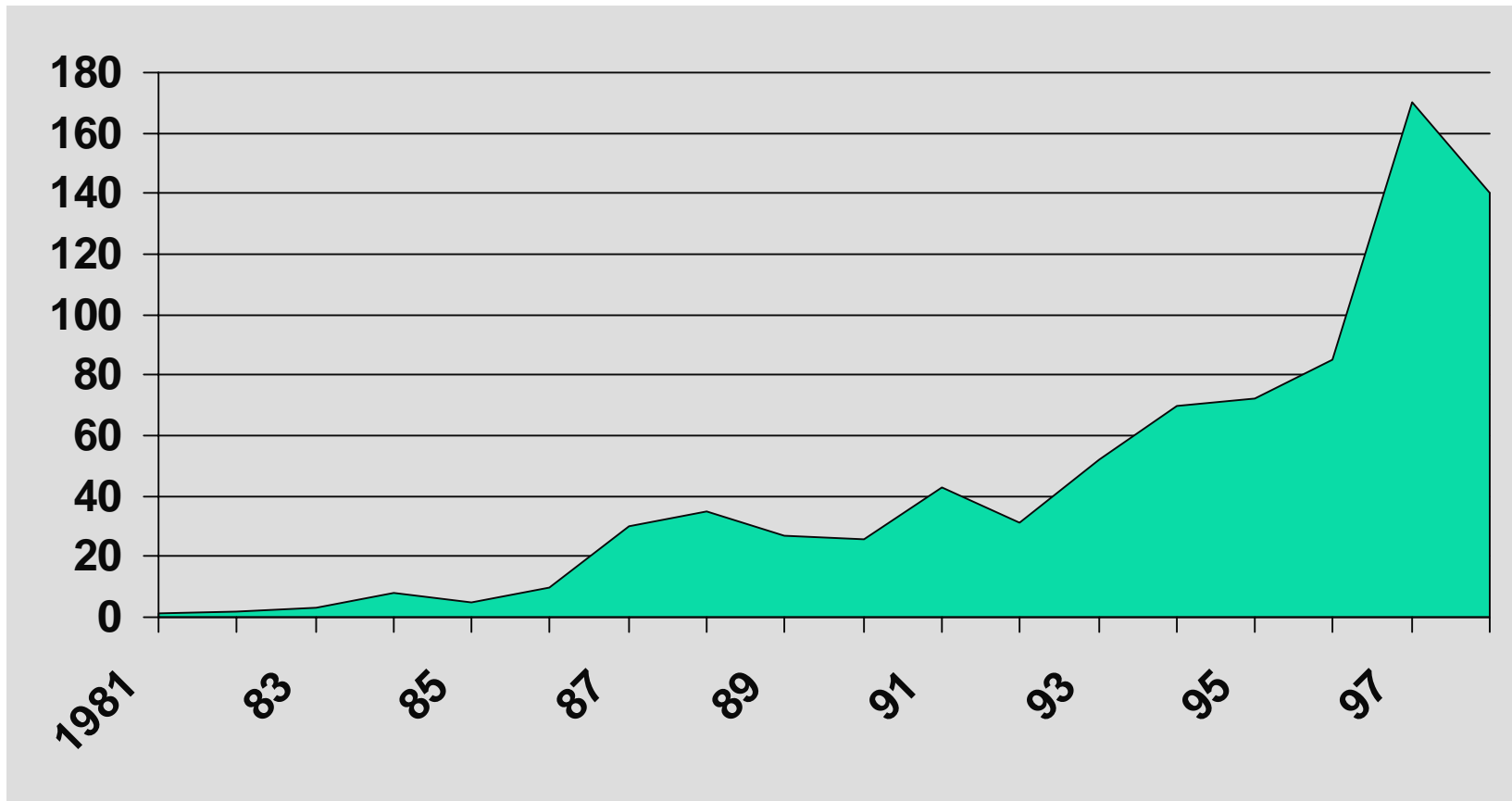
# Number And Value Of Private Placements On US Markets In 1998

<u>Security Type</u>	<u># Of Offerings</u>	<u>Value \$US Bn</u>
Overall Private Placements	4,049	\$464
Rule 144A Offers	2,635	\$336
Straight Debt	3,450	\$363
Plain Vanilla Equity	417	\$75
Yankee Private Placements	1,110	\$147

# **The Importance Of Privatizations To Global Capital Markets**

- **Not Included In Most Previous Totals Of International Common Stock Issuance**
- **The 18 Largest Stock Offerings In History Have All Been SIPs**
- **675+ SIPs Have Raised Almost \$700 Billion Since 1980, Over Two-Thirds Of This Since 1990**
- **Outside Of Entire US Corporate Sector, SIPs The Largest Total Equity Offerings Ever**
- **Have Transformed Liquidity, Total Capitalization Of Most Non-US Stock Markets**

# Privatization Proceeds \$US Billions



# Major Changes To The Investment Banking Industry Since 1970

- **Major Changes Began In US In Early-1970s**
  - After DLJ's 1970 IPO, Most Firms Went Public
  - Collapse Of Bretton Woods, Rise Of OPEC In 1973 Increased Volatility In Financial Markets
  - ERISA Of 1974 Mandated Prudent Man Rule For Pension Fund Managers
  - May Day 1975 Repeal Of Fixed Commissions
- **Changes Accelerated In 1980s:**
  - Rule 415 (Shelf Registration) Adopted In 1982
  - Wave Of Mergers And Consolidation

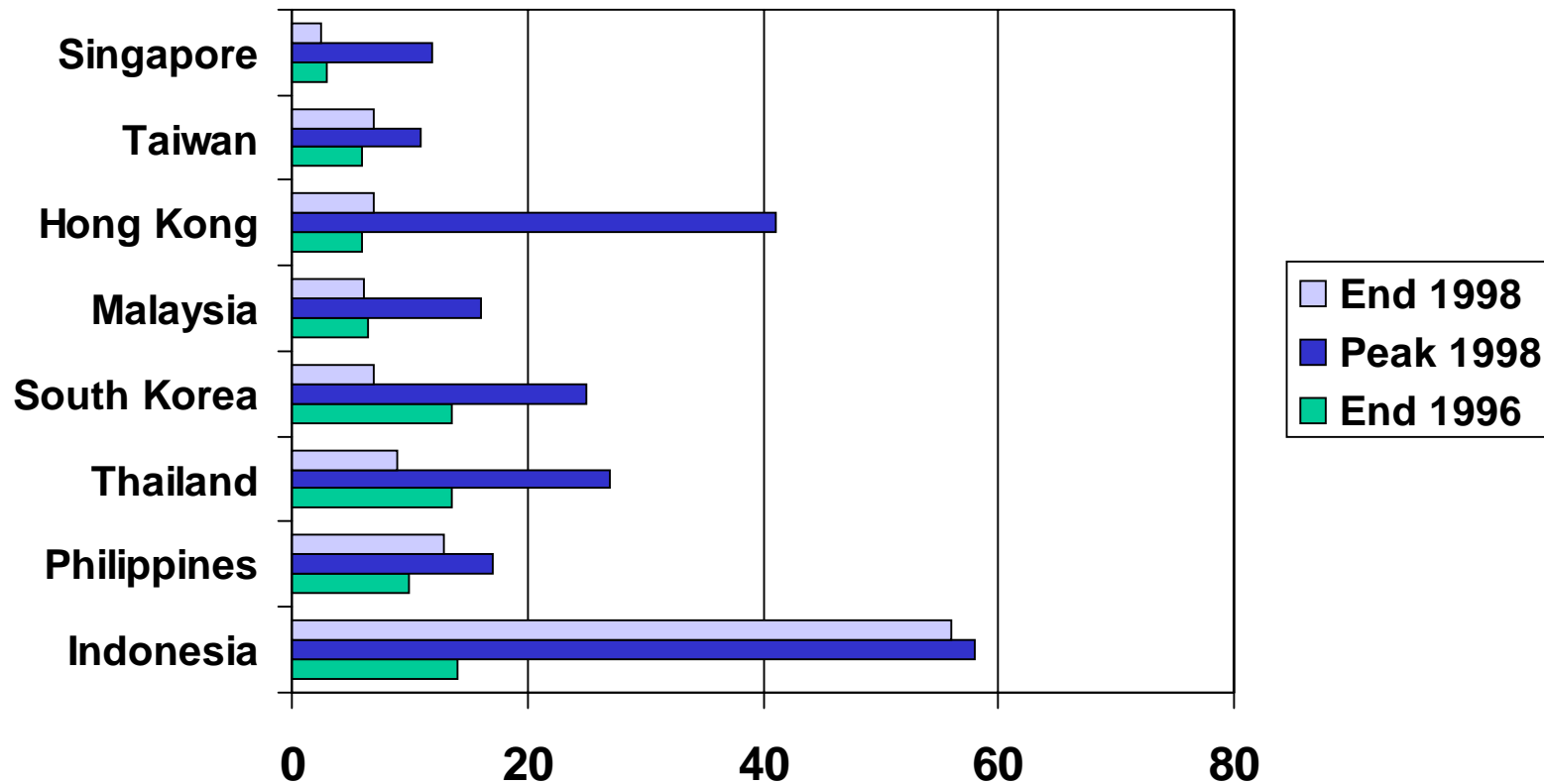
# **Major Changes To The Investment Banking Industry Since 1970 (Cont.)**

- **International Capital Markets Began To Grow Dramatically Shortly After US Markets:**
  - UK Markets Propelled By Privatizations, Big Bang
  - Privatizations, Competition, Deregulation Also Boosted Other European Markets
  - International P/F Investment Began In 1980s, Surged In 1990s
  - EEC & EU Market Integration Initiatives
  - Development Of GDR In 1990 For Equity Offers
- **US Adoption Of Rule 144A Opened New Market**

# Shocks To International IB Industry During Mid & Late-1990s

- **As Markets Grew, They Became More Volatile:**
  - Mexican Devaluation & Tequila Effect Shocked Latin American Operations, Issues (Dec 1994)
  - Asian Economic Crisis Destroyed Great Wealth, Turned P/F Investment Negative (July 1997)
  - Russian Default Caused Flight From Risky Assets In All Financial Markets (Aug 1998)
  - LTCM Near-Collapse Almost Disastrous (Sep 98)
- **Somehow, Industry Survived & Prospered**
  - However, Late 1998 A Very Frightening Period

# Asian Financial Markets Were Devastated By Crisis



# **Investment Banking Trends Emerging In 1999**

- **Tremendous Surge In Euro-Denominated Securities After Launch**
  - E15 bn First Two Months Exceeded \$ Total
- **Continuing Growth In Issuance By US Firms**
  - IPO Market Dominated By Internet Offerings
- **Rebirth Of Investor Interest In Emerging Markets**
- **Continuing Surge In M&A Activity, Privatizations**
- **The Race To Join The Global Bulge Bracket**

## **Topic 2:**

# **Key Players In The International Investment Banking Industry**

# **Everybody Wants To Be An Investment Banker**

- **Extremely Attractive Industry Due To Growth, Profitability, Glamour, and Economic Impact**
- **Long Dominated By “Bulge Bracket” US Firms**
- **Most Investment Banking Houses Now Part Of Larger Financial Groups**
- **European Commercial Banks Have Tried To Buy Their Way Into Top Ranks**
- **American Firms’ Grip On US Market, M&A Expertise Key Competitive Advantages**

# **The Life And Death Importance of League Tables**

- **Rankings of IB Firms Compiled By Euromoney, IDD Called League Tables**
- **Compile Rankings For Many Categories**
- **Firms Tend To Emphasize Those Where They Look The Best (Security, Region, Currency, etc)**
- **Great Stability in Relative Rankings--The Bulge Bracket Rarely Changes**
- **Firms Both Compete And Cooperate On Deals**
- **Lead Manager Position Carries Most Prestige And Largest Fees**

# **Top 15 Investment Banking Firms, Ranked By 1998 Underwriting**

<b><u>Company</u></b>	<b><u>Total Proceeds, \$Bn</u></b>
<b>Merrill Lynch</b>	<b>\$357</b>
<b>Salomon Smith Barney</b>	<b>\$250</b>
<b>Morgan Stanley Dean Witter</b>	<b>\$249</b>
<b>Goldman, Sachs</b>	<b>\$237</b>
<b>Lehman Brothers</b>	<b>\$168</b>
<b>Credit Suisse First Boston</b>	<b>\$163</b>
<b>J.P. Morgan</b>	<b>\$128</b>
<b>Bear, Stearns</b>	<b>\$92</b>

# Top 15 Investment Banking Firms, Ranked By Underwriting (Cont)

<u>Company</u>	<u>Total Proceeds, \$Bn</u>
Warburg Dillon Read	\$83
Chase Manhattan	\$79
Donaldson, Lufkin & Jenrette	\$62
ABN AMRO	\$61
Deutsche Bank	\$58
PaineWebber	\$54
Paribas	\$47

# **How To Tell The Key Players From Each Other**

- **Some Countries Over-Represented: US (10), Switzerland (2), Netherlands (1)**
- **Other Countries Under-Represented: France (1), Germany (1), Japan (0)**
- **Five Are Stand-Alone IB Firms**
- **Five Are Commercial Banks With IB Arms**
- **Five Are Subsidiaries of Financial Groups**
- **All Pursuing Similar Strategies, But Have Varying Strengths & Weaknesses**
- **Examine Each Firm In Turn**

# Merrill Lynch



- **Headquarters: New York**
- **63,100 Employees Worldwide**
- **900 Offices in 43 Countries**
- **\$515 Billion Assets Under Management**
- **\$1.478 Trillion in Client Assets Under Management**
- **First Large US Brokerage Firm To GO Public (1970)**

[www.merrilllynch.com](http://www.merrilllynch.com)

# Salomon Smith Barney



- **Headquarters: New York**
- **35,000 Employees Worldwide**
- **500 Offices in 23 Countries**
- **Smith Barney Acquired By Travelers In 1987**
- **Travelers & Salomon Merged In 1997, Formed Salomon Smith Barney**
- **Now Part Of Citigroup, With \$700 Billion In Total Assets**

[www.salomonsmithbarney.com](http://www.salomonsmithbarney.com)

# Morgan Stanley Dean Witter

*MORGAN STANLEY DEAN WITTER & CO.*

- **Headquarters: New York**
- **494 Offices In 23 Countries**
- **\$385 Billion Assets Under Management**
- **Dean Witter Acquired By Sears, Roebuck In 1980**
- **Dean Witter Spun-Off By Sears In Early 1990s**
- **MSDW Formed In 1997 Merger Of Dean Witter, Discover & Morgan Stanley**

[www.msdw.com](http://www.msdw.com)

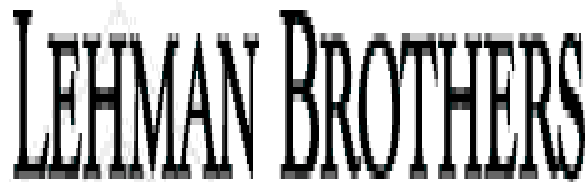
# Goldman, Sachs



- **Headquarters: New York**
- **16,500 Employees Worldwide**
- **41 Offices In 23 Countries**
- **\$195 Billion Total Assets Under Management**
- **Was Last Remaining Wall Street Partnership Until 1999 IPO**

[www.goldmansachs.com](http://www.goldmansachs.com)

# Lehman Brothers



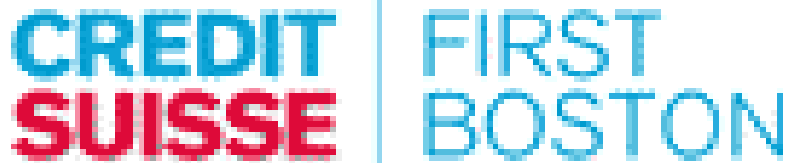
LEHMAN BROTHERS

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- **Headquarters: New York**
- **8,873 Employees Worldwide**
- **39 Offices In US, Europe, Asia**
- **\$154 Billion In Total Assets**
- **Acquired By Shearson American Express In 1984**
- **Spun-Off By American Express In 1994**

[www.lehman.com](http://www.lehman.com)

# Credit Suisse First Boston



- **Headquarters: Zurich, Switzerland**
- **14,000 Employees Worldwide**
- **60 Offices In Over 30 Countries**
- **Total Assets of \$291 Billion**
- **Wholly-Owned Subsidiary of Credit Suisse Group**
- **AA Credit Rating High For Investment Banking**

[www.corp.csfb.com](http://www.corp.csfb.com)

# J.P. Morgan

**JP Morgan**

- **Headquarters: New York**
- **Glass-Steagall Act Split House of Morgan In 1935**
- **Chartered As Commercial Bank, With Only 25%Of Revenues From IB**
- **Began Underwriting Corporate Securities 1989**
- **15,674 Employees Worldwide**
- **Total Assets \$261 Billion**

[www.morgan.com](http://www.morgan.com)

# Bear, Stearns



- **Headquarters: New York**
- **9,180 Employees Worldwide**
- **17 Offices In 9 Countries**
- **\$154 Billion Total Assets**
- **Though Independent, Frequently Mentioned As Takeover Target**

[www.bearstearns.com](http://www.bearstearns.com)

# Warburg Dillon Read



- **Headquarters: Basel & Zurich, Switzerland**
- **15,000 Employees Worldwide**
- **Offices in More Than 40 Countries**
- **SBC Acquired S.G. Warburg In 1995, Dillon Read in 1997**
- **UBS & SBC Merged In June 1998**

[www.wdr.com](http://www.wdr.com)

# Chase Manhattan



- **Headquarters: New York**
- **Primarily A Commercial Bank, Trying To Build IB**
- **\$366 Billion Total Assets**
- **Operations In 49 Countries**
- **72,683 Employees Worldwide**
- **Formed By 1995 Merger of Chase, Chemical Banks**
- **Dominant Arranger of Syndicated Loans**

[www.chase.com](http://www.chase.com)

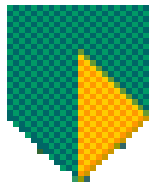
# Donaldson, Lufkin & Jenrette

Donaldson,  
Lufkin &  
Jenrette®

- Headquarters: New York
- 8,150 Employees
- 25 Offices In US, Europe, Latin America & Asia
- \$72 Billion Total Assets
- Never In Bulge Bracket, But Very Profitable
- First IPO By IB (Apr 1970)
- Acquired By Equitable In 1985, ECO Of 20% In 1995.
- Equitable Still Holds 71%

[www.dlj.com](http://www.dlj.com)

# ABN AMRO



ABN AMRO

- **Headquarters: Amsterdam, The Netherlands**
- **Primarily Commercial Bank, Formed In 1991 Merger**
- **Operates In 64 Countries**
- **\$450 Billion Total Assets**

[www.abnamro.com](http://www.abnamro.com)

# Deutsche Bank

Deutsche Bank



- **Headquarters; Frankfurt, Germany**
- **75,306 Employees Worldwide; Soon 100,000**
- **Total Assets Will Soon Be About \$1 Trillion, Making It The World's Largest Bank**
- **Commercial Bank With Lofty IB Ambitions**
- **Acquired Morgan Grenfell In 1989, Acquiring Bankers Trust (& Alex Brown) Now**

[www.deutsche-bank.com](http://www.deutsche-bank.com)

# PaineWebber



- **Headquarters: New York**
- **18,051 Employees**
- **305 Offices Worldwide**
- **Total Assets \$367 Billion**
- **Serves More Than 2 Million Individual Clients**
- **Acquired Kidder, Peabody In 1994**
- **Often Rumored As A Takeover Target, Though Still Independent**

[www.painewebber.com](http://www.painewebber.com)

# Paribas



- **Headquarters: Paris, France**
- **20,000 Employees Worldwide**
- **220 Offices In 60 Countries**
- **\$245 Billion (Dec 1997)**
- **Nationalized In 1982, Then Privatized By French Government In 1987**
- **Engaged In Three-Way Takeover Battle With BNP, Societe Generale**

[www.paribas.com](http://www.paribas.com)

# **Topic 3:**

## **Capital Markets And The Three Basic Models Of Corporate Finance**

# The Three Basic Models of Corporate Finance

- **Three separate corporate finance models (or systems) have emerged in recent years:**
  - The capital-market-based system
  - The financial-intermediary-based system
  - The industrial group system
- **These models are associated with, respectively:**
  - The US, Britain, & Canada (especially the US)
  - Europe (espec. Germany), developing countries
  - Japan (*Keiretsu*), Korea (*Chaebol*), other Asian countries

# **All Three Models Have Been Successes & Have Many Similarities**

- **All The Key Countries Involved Are Democracies**
- **All The Key Countries (Now) Stress Private Over Public-Sector Ownership**
- **All The Key Countries Involved Have Large, Rich Consumer Markets**
- **All Three Systems Are Dominated By Numerous Large, Publicly-Traded Firms**

# **Systems Differ With Respect To:**

- **Primary Source(s) Of External Financing**
  - Banks Vs. Markets
- **Ownership Structure Of The Firm**
  - Atomistic Vs. Concentrated
- **Stock Market's Role In Monitoring Managers**
- **Power Of Professional Managers Vs. Other Stakeholders**
- **Corporate Governance Role Of Fincl Institutions**
- **Rights & Duties Of Individual Shareholders**

# **Systems Differ With Respect To (Cont):**

- **Importance of equity-based compensation for executives**
- **Importance of formal contracts and regulations**
- **Strategic role of mergers & acquisitions in corporate control**
- **Legal System Used:**
  - British Common Law
  - German Or Scandinavian Commercial Law
  - French Civil Law

# **Characteristics Of The Capital-Market-Based System Of Corporate Finance**

- **Many Large, Independent, Publicly-Traded Firms**
- **Great Reliance On Capital Markets--Rather Than On FIs--For External Financing**
- **Very Large, Efficient Capital Markets**
- **Small Stockholders The Focus Of Corporate Governance; Much Disclosure Required**
- **Great Reliance On Equity-Based Compensation**
- **Very Active Market For Corporate Control, Including Hostile Takeovers & LBOs**
- **Heavy Reliance On Formal Contracts**

# **Strengths Of The Capital-Market-Based System Of Corporate Finance**

- **Can Raise Huge Sums For Corporate investments**
- **Spreads Economy's Financial Risk To Diversified Investors**
- **Transparency--Becoming Increasingly Important**
- **Allocative Efficiency--Capital Goes To Best Use**
- **Allows For Great Specialization Of Labor**
- **Liquid Capital Markets Allow Private, Funded Pension System**
- **Good At Financing Entrepreneurial Growth Firms**
- **Technology Seems To Favor Capital Markets**

# **Weaknesses Of The Capital-Market-Based System Of Corporate Finance**

- **Separation Of Ownership And Control**
- **Managers Have Strong Entrenchment Incentives**
- **Hard To Enforce Proper Investment Incentives:**
  - Over-Investing In Negative-NPV Projects, Or
  - Under-Investing In Positive-NPV Projects With Long-Maturity Payoffs
- **Required Information Disclosure Often Excessive**
  - Can Reduce Value Of Proprietary Information
- **Bankruptcy Procedures Very Cumbersome**

# **Characteristics Of The Financial-Intermediary-Based Corp Fin System**

- **Relatively Few Large, Independent, Publicly-Traded Companies (Except Privatized Firms)**
- **A Few, Very Strong Commercial Banks Dominate Corporate Financing**
- **Commercial Banks Serve As Universal Banks**
- **Capital Markets Play Small, But Growing, Role In Corporate Finance**
- **Very Little Mandated Information Disclosure**
- **Far Less Reliance On Professional Managers**
- **Relatively Inactive Corporate Control Market**

# **Strengths Of The Financial- Intermediary-Based Corp Fin System**

- **Intermediaries Make Natural Corporate Monitors**
- **Commercial Banks Enjoy Natural Comparative Advantages At Raising & Allocating Funds**
- **FIs Can Build Long-Term Relationships With Client Firms**
- **FIs Better Able To Handle Borrower Financial Distress (Laws Tend To Favor Creditors)**
- **Able To Commit To Funding Multi-Year Client Investment Programs**

# **Weaknesses Of The Financial- Intermediary-Based Corp Fin System**

- **Inherent Conflict Of Interest For Bankers  
(Creditor & Shareholder)**
- **Little Transparency In Corporate Financing And  
Corporate Governance Systems**
- **Large Scale Debt Or Equity Financing Through  
FIs Can Be Very Costly**
- **Unless Financial System Very Competitive, Can  
Lead To Collusion & High Financing Costs**
- **Information Processing Technology Is Weakening  
The Value Of Bank Franchises**

# **Characteristics Of The Industrial-Group System Of Corporate Finance**

- **National Economies Are Dominated By A Few Powerful Industrial Groups (*Keiretsu* & *Chaebol*)**
- **Lead Company (Usually A Commercial Bank) Exercises Control & Coordinates Group Activities**
- **Groups Are Their Countries' Leading Exporters & Enjoy Close Relationships With The Government**
- **Capital Markets Play Little Role In Corporate Finance Or Governance**
- **Significant Share Ownership Is Rare For Group Company Managers (Except *Chaebol*)**

# **Strengths Of The Industrial-Group System Of Corporate Finance**

- **Groups Seem Able To Achieve Rapid Economic Development**
- **Groups Can Build Networks Of Strong, Inter-Related Companies With Vast Capabilities**
- **Strong Intra-Group Links Allow Efficient Financial Contracting**
- **Allows Rapid Spread Of Market Information, Manufacturing Expertise, New technology**

# **Weaknesses Of The Industrial-Group System Of Corporate Finance**

- **Cross-Subsidization: Strong Companies Often “Taxed” To Subsidize Weaker Companies**
- **Very Hard To Inject Market Discipline Into Group Contracting**
- **Groups Impose Immense Costs On Consumers**
- **Severe Weaknesses And Fragility Of “Crony Capitalism”**
- **Government Officials Typically Play Critical--But Unaccountable--Roles In Corporate Finance**

# Conclusions

- **Capital-Market Based System Seems To Be “Winning”**
- **All Countries Trying To Promote Capital Markets For Economic & Pension Funding Reasons**
- **Technological Advantage Of Capital Markets Is Proving Decisive**
- **Industrial Group System Seems To Be A “Failed Economic Model”**
- **Key Questions: What Model Will Be Chosen By China, Russia, & India?**

# **Topic 4:**

## **Investment Banking Practices In International Debt Security Markets**

# The International Bond Market

- **There Is No Unified International Bond Market**
- **Instead, International Bond Market Has Three Broad Market Groups:**
  - **Domestic Bonds:** Issued By Local Borrower, In Local Currency
  - **Foreign Bonds:** Sold On Local Market By Foreign Borrower, In Local Currency
  - **Eurobonds:** Sold Mainly In Countries Other Than The One Whose Currency Bond Is In
- **Wide Variety Of Instruments Issued**

# **Statistical Overview Of World Bond Markets**

- **Total Worldwide Value Of Publicly-Issued Bonds Probably Close To \$25 Trillion**
- **US Domestic Market Accounts For ~45% Of Total**
- **Government Debt Accounts For Roughly Two-Thirds Of Total**
- **Roughly Half Of All Bonds Denominated In \$US**
- **20-25% Of Bonds Denominated In Yen**
  - Share Rising Due To Huge Budget Deficits
- **Remaining 25-30% In European Currencies**
  - Euro Share Certain To Rise Over Time

# **Features Of US Domestic Bond Market**

- **Treasuries O/S Jumped From \$1 Trillion To Over \$5 Trillion Due To 1981-96 Deficits**
- **Rule 415 Dramatically Increased Size, Growth Rate Of Corporate Market**
- **Declining Interest Rates 1991-99 Has Prompted Refinancings**
- **Securitization A Very Important Feature**
- **Municipal Bond Market Unique To US**
- **High-Yield Market Once Again Vibrant**

# Features Of Key Non-US Domestic Bond Markets

- **Many Domestic Bond Markets Relatively Small Until 1990s; Now Growing Fast**
- **Many Were Reserved For Governments, Banks**
  - French, Italian Markets Reserved For Govt
  - Japanese Market For Govt, Long-Term Banks
  - UK, Swiss Markets Always More Open To Firms
  - German Market Small Until Unification
- **Government Bonds Always Key Assets, Issues**
  - Gilts (UK), OATs (France) Widely-Held
  - IBs Help Issue Bonds, But Low Margins

# Foreign Bond Markets

- **Largest Foreign Bond Markets Traditionally US, Japan, Switzerland**
  - \$241 Bn Yankee Bonds In 1998, \$13 Bn In 1990
- **Often Given Colorful Names**
  - Samurai (Japan), Bulldog (UK), Heidi (Swiss), Rembrandt (Holland), Matador (Spain) Bonds
- **Foreign Bonds Must Meet Local Listing Rules**
  - Yankee Bonds Must Meet SEC Regulations
  - SF Can Be Used Only Foreign, Not Eurobonds

# Foreign Bond Markets (Cont.)

- **Governments Have Reduced Withholding Taxes**
  - US Interest Equalization Tax Repealed in 1984
  - Tax Treaties Determine Rates Of Withholding
  - Swiss Stamp Tax Encourages Offshore Trading
- **Principal Borrowers In Foreign Bond Markets:**
  - MNCs Needing Funding In Local Currency
  - Multilateral Organizations, Especially World Bank
  - National Governments (Forex Reserves), SOEs

# Eurobond Market Overview

- **Eurobond Market Is Totally Self-Regulated**
  - Birth, Growth Of Market Prompted By Regulation
  - Issuing, Trading Rules Set By ISMA
  - Clearing Through Euroclear Or Cedel
  - Typically Listed On Luxembourg Stock Exchange
- **Extremely Innovative, Efficient Market**
- **Fraction Of Eurobonds In \$US Usually 30-65%**
  - Increases When \$ Strong, Declines When \$ Weak
  - US Citizens Cannot Buy Newly-Issued Bonds

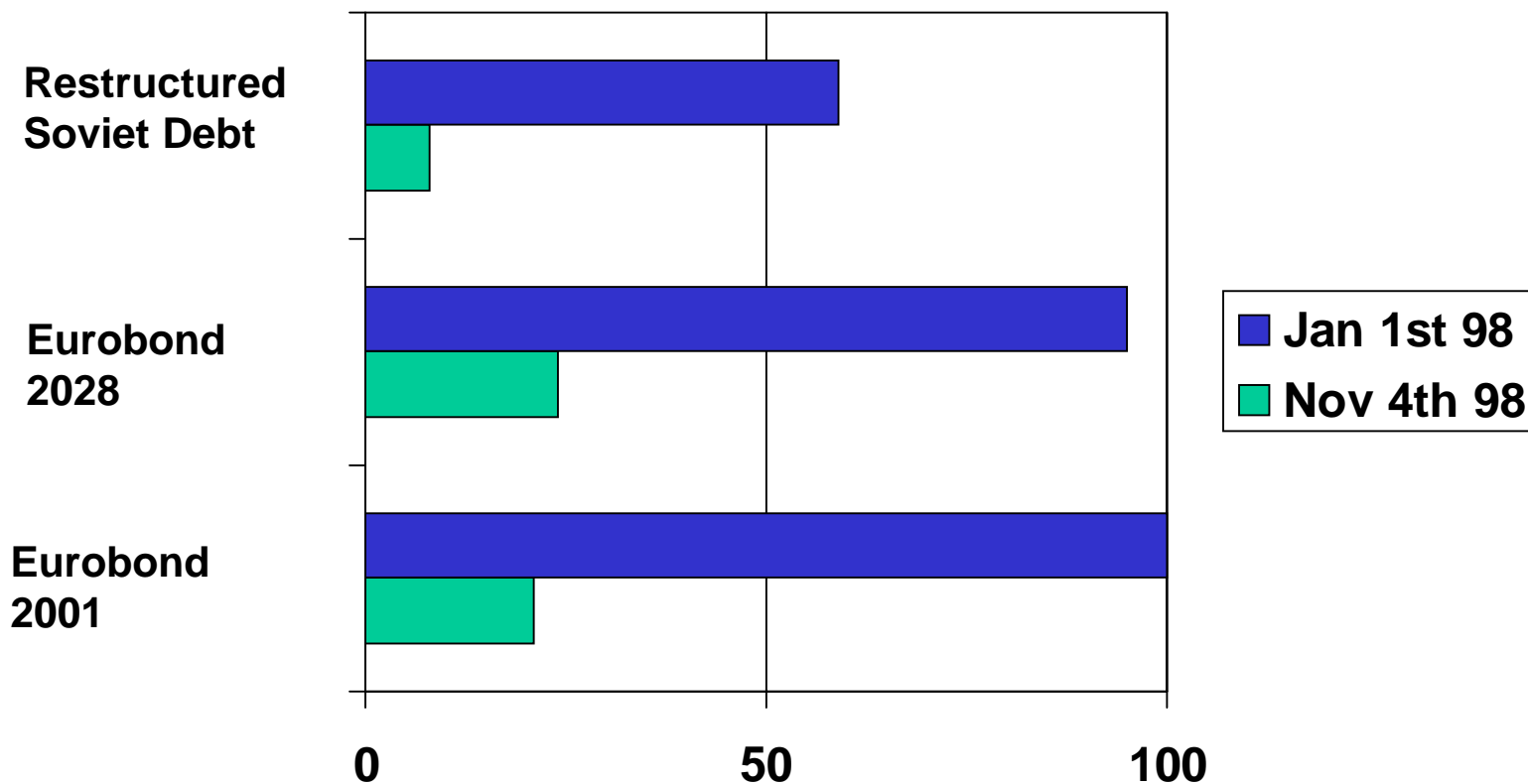
# Patterns Observed In Eurobond Issuance

- **Almost Always Bearer Bonds**
- **Frequently Dual-Currency Instruments**
- **Typically Intermediate-Term Debt (5-10 Years)**
- **Underwriting Syndicate Often Very Large**
  - Can Have 50-100 Banks For Large Issues
  - US Commercial Banks Actively Participate
  - Can be Sold In 5 Weeks Or Less
- **Often Have Complex Options, Other Features**
  - Japanese Convertibles Very Popular Until 1990
- **Typically Pay Interest Annually**

# Emerging Market And Brady Bonds

- **Few International Bond Issues By LDC Until 1990**
  - Debt Build-Up Of 1970s Mostly Bank Credit
  - Latin American Countries Gained Access In 90s
  - Asian “Tigers” Had Access Until 1997
- **Collapse Of Communism Had Major Impact**
  - Eastern European Countries Soon Had Access
  - Even Russia Could (Briefly) Issue Eurobonds
- **Brady Bond Program Very Successful**
  - Non-Traded Bank Debt Collateralized, Securitized
- **Soon Likely To See First Eurobond Defaults**

# Russia' Access To Eurobond Market Was Brief & Painful



# The Importance Of Swaps In International Bond Markets

- **Many Eurobond Issues Actually Used For Swaps**
- **Swaps Involve Trading Streams Of Liability Payments Between Two Parties**
  - Can Be Interest Rate Or Currency Swaps
  - Only Net Amount Trades Hands
- **Allows Each Party To Borrow Where They Have Comparative Advantage**
  - US Firm Needing Floating-Rate FF Debt
  - Can Borrow Cheaply In Fixed-Rate \$, Then Swap
- **Total Value Estimated To Be Several \$Trillion**

# Key Recent Innovations In International Debt Markets

- **Floating Rate Notes Launched Early 1980s**
  - Shifts Interest Rate Risk To Borrower
  - Proven Very Popular With Investors
  - Critical Parameters: Spread & Index
- **Bonds Linked To Gold, Oil, Other Commodities**
- **Governments Issuing Inflation-Adjusted Bonds**
- **Pre-1999 European Bonds Often “Tributary”**
  - Automatically Convert To Euro If Country Joins
- **Euro Launch Certain To Become The Single Most Important Innovation Ever**

# **Topic 5:**

## **Bank-Based Investment Banking Products: Syndicated Loans & Project Finance**

# Where Investment & Commercial Banking Overlap

- **Course Focus On Raising Capital For Firms**
- **Mostly Done By Investment Banks Or By Commercial Banks That Have Purchased IB**
- **For Two Important Products, Markets Overlap:**
  - Syndicated Loans
  - Project Finance
- **Syndicated Loan Market Larger Than Any Other Single Debt Market**
  - Over \$13 Trillion Since 1980, Over \$1 Trillion/Year
  - Now Largest US Corporate Financing Market

# History Of Syndicated Loan Market

- **Syndicated Loans Long Observed In US Markets**
  - Needed Because Of McFadden Act's Effects
  - One Of Few Remaining “Unchallenged” Markets
- **Modern Eurocurrency Loan Market Dates To 1969**
  - Traditionally Based On Eurodollar Time Deposits
  - “Recycling” Of Petrodollars In 1970s To LDCs
  - Today Overwhelmingly A Corporate Loan Market
  - Takeover Loans The Largest, Most Profitable
- **US Banks Dominate Arranging, But Not Funding**
  - Chase Alone Has 23% Market Share

# Typical Features Of Syndicated Loans

- **Most Are Significantly Larger Than Bond Issues**
  - Average Size \$146 Million, \$1 Billion+ Common
  - E53 Billion Olivetti Loan Largest Financing Ever
- **Can Be Arranged Very Quickly**
  - \$14 Bn Loan To Chevron Arranged In 48 Hrs
- **Structured As Line Of Credit, So Very Flexible**
  - Can Be Drawn-Down, Repaid As Borrower Needs
- **Trend Is To Structure As Security Issues**
  - Attractive For Banks, Issuers & Investors

# Uses Of Syndicated Loans

- **Uses Of 90,784 Syndicated Loans Since 1980:**
  - Corporate Control: 10,795 Loans (\$2.3 Trillion)
  - Capital Structure: 25,313 Loans (\$5.3 Trillion)
  - General Purpose: 39,653 Loans (\$4.3 Trillion)
  - Project Finance: 4,956 Loans (\$634 Billion)
  - Fixed-Asset Loans: 4,680 Loans (\$410 Billion)
- **Most Common Use Today To Fund M&A**
  - Record Volume Of Takeovers In US, Europe
  - Larger Avg Size (\$212m), Spread Than Others

# The Syndicate Structure Of Syndicated Loans

- **Lead Manager Role The Most Prestigious & Risky**
  - Depending Upon Loan Size, May Invest \$50 Mn+
  - Co-Leads Might Have To Put Up \$25 Mn
  - Participating Banks \$5-15 Mn Required
  - Could Have Over 30 Banks For Large Loans
  - Average Syndicate Size 11 Banks
- **Lion's Share Of Fees Kept By Lead, Co-Leads**
  - Average Max Participation Fee 37 Basis Points
  - Average Initial Commitment Fees 31 Basis Points

# The Pricing & Maturity Of Syndicated Loans

- **Most Are Priced As Spread Above LIBOR**
  - 69% Priced Versus LIBOR
  - Other Benchmarks: SIBOR, HIBOR, US Prime
  - Only 6% Have Fixed Rate Pricing
  - Average Spread Vs. LIBOR: 134 Basis Points
- **Loans Typically Short To Intermediate Term**
  - Average Maturity 4.8 Years
  - Except For PF, Loans Over 10 Years Fairly Rare

# Nationalities Of Syndicated Loans Borrowers, 1980-99

<u>Borrower Nationality</u>	<u>Total Value, \$Bn</u>	<u>% Of Total</u>
United States	\$8,170	61.4%
United Kingdom	\$1,230	9.3%
Other EU	\$1,383	10.4%
South East Asia	\$688	5.2%
Australia	\$349	2.6%

# The Rise Of Project Finance

- **Specialized Loan Form Pioneered In North Sea**
- **Limited Or Non-Recourse Lending To A Specially-Created Vehicle Company**
- **Ideally Suited For Infrastructure Lending In Relatively Risky Countries**
- **Though Many Successes, Best Known For Three Financial Failures:**
  - Channel Tunnel (Eurotunnel)
  - Euro Disneyland
  - Dabhol India Power Project (Enron)

# Characteristics Of Project Finance Lending

- **Stand-Alone Financing; No Corporate Backing**
- **Highly Complex Contracting Between Parties:**
  - Project Sponsors (MNCs, Governments)
  - Vehicle Company: Owns & Operates Project
  - Lenders & Guarantors (ECAs, World Bank)
- **Long-Term Lending For Tangible Assets**
  - Natural Resource Or Energy Projects
  - Infrastructure (Roads, Tunnels, Bridges, Ports)
- **Build Operate Transfer (BOT) Often Used For Infrastructure Projects**

# Project Finance Borrowers, By Industry, 1980-99

<u>Borrower Industry</u>	<u>Total Value, \$Bn</u>	<u>% Of Total</u>
Electric Utility	\$137	21.5%
Oil & Gas	\$120	18.8%
Communications	\$51	8.1%
Transportation	\$49	7.7%
Mining & Natural Resources	28	4.4%

# Project Finance Borrowers, By Nationality, 1980-99

<u>Borrower Nationality</u>	<u>Total Value, \$Bn</u>	<u>% Of Total</u>
South East Asia	\$151	23.8%
United States	\$107	16.8%
United Kingdom	\$92	14.5%
Other EU	\$66	10.3%
Middle East	\$59	9.3%
Latin America	\$52	8.3%

# How Project Finance Loans Differ From Other Syndicated Credits

- **Smaller Loans, But Larger Syndicates**
  - Average Size \$128 Mn (Versus \$146 Mn)
  - 14.5 Banks In PF Loan Syndicate (Vs. 10.7)
  - Higher Total Fees For PF: 93 bp Vs. 67.7 bp
- **PFLs Much Longer Term, To Riskier Borrowers**
  - Average Maturity 8.6 Yrs Vs. 4.8 Yrs
  - Average Risk Rank of 31.8 For PFL Vs. 12.8
  - Only 11.6% Of PFL To US Borrowers Vs. 56.9%
- **Pricing, However, Very Similar**
  - Average Spread On PFL 130 bp Vs. 134 bp

# Six Largest Project Finance Loans Since 1980

<u>Borrower Name</u>	<u>Launch Date</u>	<u>Amount, \$Bn</u>
Eurotunnel plc	June 90	\$13.2
Eurotunnel plc	Aug 87	\$7.9
Formosa Plastics	Mar 93	\$5.5
Qatar Liquefied Gas	Feb 93	\$4.2
Railtrack plc	Nov 95	\$3.7
NEXTEL Communicatns	Jan 98	\$1.7

# Summary Of Syndicated Loans & Project Finance

- **Both SL And PFL Have Emerged As Important Capital-Raising Tools**
- **Seem To Be Gaining Market Share**
  - SL Especially Useful For M&A Financing
  - PFL Can Fund Otherwise Unfinanceable Projects
- **Ideal Instruments For Corporate Borrowers, Unless Truly L-T Funding Required**
  - Never Shut Down Last Year, As Markets Did
- **One Of Few Areas Where Commercial Banks Have Held Market Share**

# **Topic 6:**

## **International Stock Markets & Privatization's Critical Role In Their Development**

# **Non-US Stock Markets Historically Limited In Scale & Scope**

- **Outside Of US & UK, National Stock Markets Small, Dominated By A Few Stocks**
  - US, UK, Swiss Market Cap > 100% Of GDP
  - Most European Market Caps <50% Of GDP
  - Top 10 US Stocks < 15% Of Market's Total Value
  - Top 10 Stocks Equal 25-70% Of Value Outside US
  - US Market Typically Represents 35-50% Of Total
- **Before Privatizations, Few Non-US IPOs, Few S/Hs**
  - More IPOs In US During 1994 Than In Germany During Entire Post-War Era

# **All Stock Markets Have Grown Immensely During 1990s**

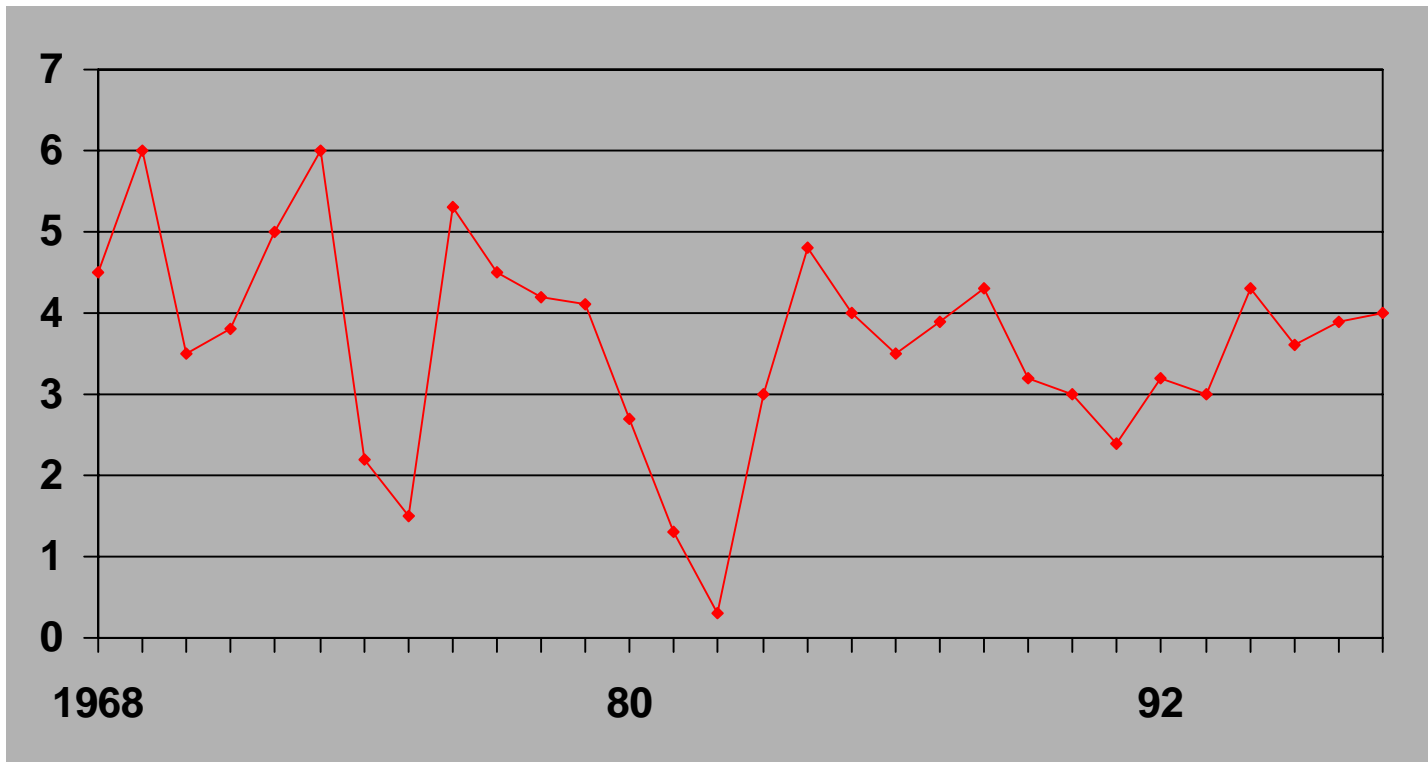
- **Total World Market Capitalization >\$25 Trillion**
- **DJIA Was 775 In 1982; Now 11,000**
  - Many European, Asian Markets Up Even More
- **Average US Trading Volume Increased 20 Times Since Late-1970s**
  - Non-US Markets Even Greater % Growth
  - Emerging Markets Greatest % Growth & Volatility
- **Number Of S/Hs has Increased Phenomenally**
  - Roughly Half Of US Adults Own Stock
  - Figures In EU Often In 20-35% Range

# **Factors Accounting For Stock Market Growth**

- **Economic Prosperity & End Of Cold War**
- **Spread Of Economic Liberalism, Democracy**
- **Liberalization Of Trade In Goods & Services**
- **Spread & Increased Capabilities Of Technology**
- **Rapid Growth Of FDI, Portfolio Investment**
- **Spread Of Funded Pension Systems**
- **European Integration & Launch Of Euro**
- **Growth Of “Equity Culture” In EU**
  - Evidenced By Success Of German Neue Market

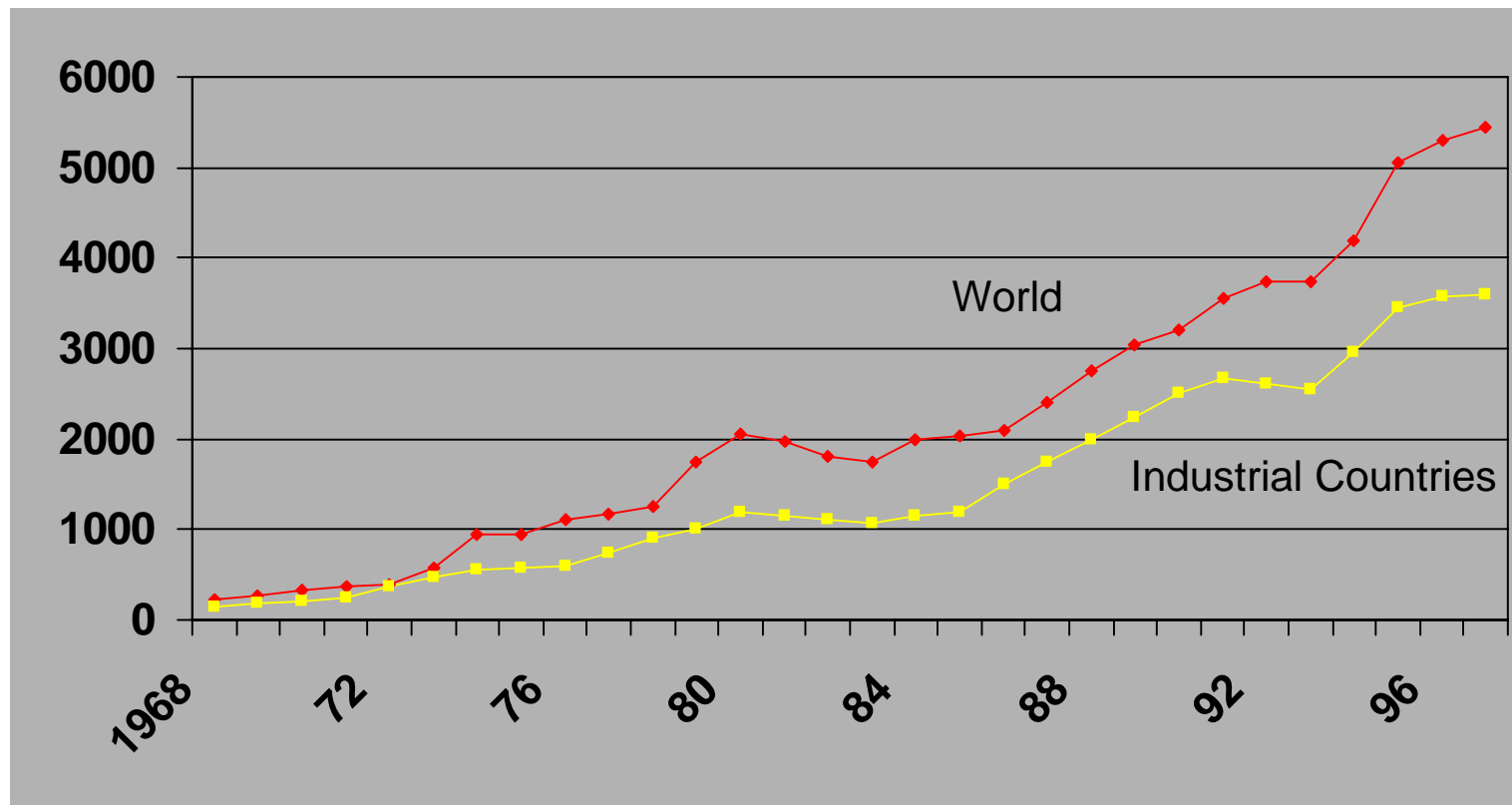
# World Economic Growth Rates, 1968-1997

Percent Change in "World GDP" Over Previous Year



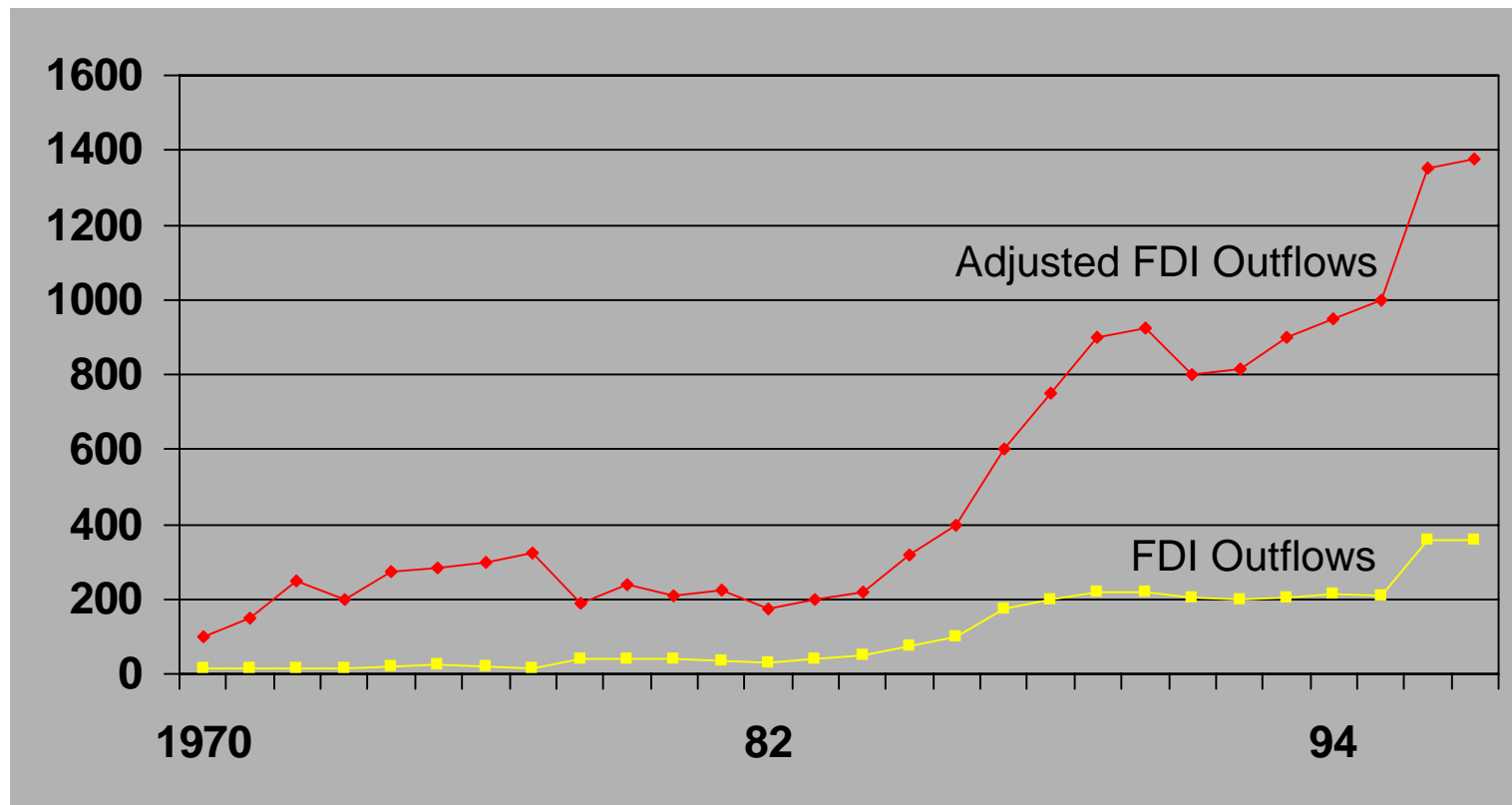
# The Growth In World Trade, 1968-1997

Total Value Of Exports, \$ Billions



# Foreign Direct Investment Has Grown Dramatically Since Early-1980s

Investment Flows By Multinational Corporations, \$ Bn



**But Most Important Reason For  
Growth Of Non-US Stock Markets**

# **PRIVATIZATION**

**(Particularly Share Issue Privatizations)**

# Brief History Of Privatization

- **FRG's Adenauer Government Actually First (1961)**
- **Small British Petroleum, Other Sales (1977)**
- **First Thatcher Government (1979-83)**
- **The Turning Point: British Telecom (Nov 84)**
- **Chile Shows Privatization Possible in DCs (80-85)**
- **The French Chirac Government (1986-88)**
- **Privatization Spreads To Asia (NTT 1987-88)**
- **Telefonos de Chile Pioneers ADRs (1990)**
- **European SDs Embrace Privatization (Since 1993)**

# The Impact of Privatization

- **Has Significantly Reduced State's Role in OECD**
  - SOEs Effectively Eliminated From UK Economy
  - Rapidly Shrinking Role In Western Europe, Asia
- **Transition Economies Have Been Transformed**
  - SOE Role Cut Up To Two-Thirds In Eastern Europe
  - Russia Privatized, But Not Commercialized
- **Much Less Change In Developing Countries**
  - Little Change In Africa, Latin America
  - Non-OECD Asia Has Actually Increased
- **Little Impact Thus Far In China, India**

# Privatization's Impact on Stock Market Capitalization

- **34 SIPs Firms Have Market Caps > \$15 bn**
- **75 of Business Week Global 1000 Are SIPs**
- **29 of BW Top 100 Emerging Markets Firms SIPs**
  - Four Largest Firms All SIPs
  - SIPs Account For 36.6% of Top 100 Total Value
- **Total Capitalization of 104 SIPs, \$1.683 Trillion**
  - Equal to 9.7% of Combined BW Samples
  - Equal to 20.1% of non-US Firms Market Cap
- **SIPs Almost Always Country's Largest Cap Firm**

# Market Value & Country Rank of Privatized Firms (BW Global 1000)

Company	Rank	Mkt Cap (\$ mm)
Nippon Tel & Tel	1	130,911
British Petroleum	2	85,283
Deutsche Telekom	2	73,640
British Telecom	6	66,261
ENI	1	56,424
France Telecom	1	56,011
Telecom Italia	2	51,301
Telefonica	1	45,854

# Market Value & Country Rank of Privatized Firms (Emerging Markets)

<b>Company</b>	<b>Country</b>	<b>Mkt Cap (\$ mm)</b>
Gazprom	Russia	20,462
Telebras	Brazil	32,759
China Telecom	China (HK/SAR)	20,676
Telmex	Mexico	19,999
Hellenic Telecom	Greece	13,334
YPF	Argentina	10,983
Telekom Malaysia	Malaysia	6,871
Korea Elec Power	Korea	6,293

# Privatizations As Equity Issues

- **18 Largest Share Offerings Are All SIPs**
- **29 SIPs Larger Than \$4.4 bn Conoco IPO (Oct 98)**
- **41 Of 47 Issues Over \$3 bn Are SIPs**
- **630+ SIPs Have Raised > \$500 bn Since 1977**
- **112 SIPs Have Raised More Than \$1 bn**
- **Differences From Private-Sector Issues:**
  - Typically Pure Secondary Offerings
  - Highly Politicized Offer Terms & Share Allocations
- **SIPs Almost Always Nation's Largest Share Issue**

# The Largest Share Offerings In Financial History Are All SIPs

<b>Nov 87</b>	<b>Nippon Tel &amp; Tel</b>	<b>\$40.3 bn</b>
<b>Oct 88</b>	<b>Nippon Tel &amp; Tel</b>	<b>22.4</b>
<b>Oct 98</b>	<b>NTT DoCoMo *</b>	<b>18.4</b>
<b>Oct 97</b>	<b>Telecom Italia</b>	<b>15.5</b>
<b>Feb 87</b>	<b>Nippon Tel &amp; Tel *</b>	<b>15.1</b>
<b>Nov 96</b>	<b>Deutsche Telekom *</b>	<b>13.3</b>
<b>Oct 87</b>	<b>British Petroleum</b>	<b>12.4</b>
<b>Nov 97</b>	<b>Telstra *</b>	<b>10.5</b>
<b>Nov 98</b>	<b>France Telecom</b>	<b>10.5</b>

# Governments Use Three Basic Methods To Privatize

- **Direct (Asset) Sale:** Sale Of A Company To Another Firm Or Group Of Investors For Cash.
- **Share Issue Privatizations (SIPs):** Public Offering of Common Stock Currently Owned By Government.
- **Voucher Privatization:** Exchangeable Vouchers Distributed To Citizens For Free (Or At Reduced Cost). Convertible Into SOE Shares.

# Characteristics Of SIPs Versus Asset Sales

<b>Variables</b>	<b>SIPs</b>	<b>Asset Sales</b>
# Of Privatizations	558	831
# Of Countries	58	71
% Of Capital Sold	44%	71%
(Median)	(30%)	(76%)
\$US Offer Size, mm	\$748	\$212
(Median)	(\$138)	(\$49)
Total \$US Sold, mm	\$417,532	\$175,988

# How Politicized Are Pricing & Share Allocation Terms In SIPs?

- **Results From One Forthcoming Study:**
  - Find SIPs Significantly & Deliberately Underpriced
  - Govts Almost Always Choose Fixed Price Offers
  - Allocate Shares To Citizens, SOE Employees
  - Few Govts Sell 100%, Rarely Sell Control
  - Often Have Control Restrictions (“Golden Share”)
  - IR Directly Related To % Capital Sold, Gini Coeff
  - IR Negatively Related To Govt’s “Populism”
  - IR Not Significantly Related To Firm Size (Not AI)

# Average Pricing, Share & Control Allocation Terms In SIPs

<b>Variable</b>	<b>Initial SIPs</b>	<b>Seasoned SIPs</b>
Issue Size, \$US mm	555.7	1,068.9
Initial Return, %	34.1	9.4
% Offer At Fixed Price	85.0	61.0
Gross Spread, %	4.4	2.5
% w/Employ Allocation	91.0	65.8
Employee Allocation %	8.5	4.8
% Of Capital Sold	43.9	22.7
% w/Control Restriction	93 (UK)	76 (Non-UK)

# Have Investors Benefited From Privatization?

- **Paper Studies L-R Returns For 201 Unseasoned & 63 Seasoned SIPs From 36 Countries, 1981-97:**
  - Compute 1,3 & 5-Yr HPR In \$ And Local Currency
  - Compare HPR To Local, World & US Market Index
  - Also Compute Matching-Firm Returns Based On Currency, Size And Industry
  - Test Significance Of Net Returns, WR, % Positive
  - Document Significantly Positive LRR For IPOs
  - Find Insignificant LRR For Seasoned Issues

# **Investment Banking Practices In Privatizations**

- **Lead Privatization Underwriters Are British**
  - N. M. Rothschild The Leader Most Years
  - US Firms Still Strong (Goldman, Morgan Stanley)
- **Most SIPs Use Fixed Price Offerings**
- **Spreads Much Lower Than In Private Offers**
- **Share Allocations Vastly Different**
- **SIPs Are Cash Offers, Not Rights Issues As In EU**
- **SIPS Leading To Spread Of US-Style U/W Tools**
  - Book-Building And Price Discovery

# Topic 7:

## The Euro's Likely Impact On Global Capital Markets

# **The Long Birth Of A New Super-Currency**

- **Deep Roots Of European Monetary, Political Union**
- **Several Attempts To Fix Intra-European Forex Rates Since 1973 Collapse Of Bretton Woods**
- **German Mark Served As Benchmark Currency**
- **Convergence Began to Occur During 1980s**
- **EMU Rates Locked In 1987: Seemed To Work**
- **Maastricht Treaty 1991 Set Course For Monetary Union By 1999**
  - Established Macroeconomic Conditions For Entry
  - Only Hard Core Actually Expected In Round 1

# The Long Birth Of A New Super-Currency (Cont.)

- **Early 1990s Saw Repeated Crises**
  - UK, Italy Knocked Out Of EMS In Sept 1992
  - Narrow Currency Bands Widened In Aug 1993
  - Very Few Countries Meeting Targets Thru 1996
- **Peculiar Dynamic Took Hold In Mid-90s:**
  - No Country Wanted To Be Precluded From Entry
  - Spain, Italy, Portugal All Began Fiscal Tightening
  - Franc Fort Withstood Political, Financial Crises
  - Political Will To Succeed Became Overwhelming

# The Long Birth Of A New Super-Currency (Cont.)

- **At Final Accession Meeting, 11 Countries Invited**
  - All Who Wanted In Except Greece Allowed In
  - Greece Likely In 2001-02
  - UK, Sweden, Denmark Opted Not To Join
  - Switzerland, Norway Voted Not To Join EU
- **Euro Began Life As Currency Jan 2, 1999**
  - Began At \$1.17/E, But Then Steadily Declined
  - Notes & Coins Won't Circulate Until Jan 2002
  - Few European Citizens Enraptured By Euro

# Monetary Policy In New Euro Zone

- **European Central Bank Set Up As Monetary Body**
  - National CBs Are “Branches” Of ECB
  - Headquartered In Frankfurt, English As Language
  - Wim Duisenberg First Head (French Objected)
- **ECB Set Up To Have Great Independence**
  - Not Really Accountable To Any Elected Body
  - Not Required To Publish Minutes
  - Given Sole Task Of Maintaining Price Stability
  - Much Agitation For A “Political Counter-Weight”

# **Many Early Signs Have Been Hopeful For Euro**

- **Launch Went Well, With No Technical Problems**
- **Pricing Initially Limited To Financial Markets**
- **Overwhelming Support By European Elites For Monetary Union**
- **Begins Life With Very Low Inflation In EU**
- **Europe Growing Steadily During 1999**
- **Many Countries Hoping To Join EU & EMU**
- **Lead To Immediate Surge In Capital Market Issues Denominated In Euros**
- **EU Banks Making Strong Run For Top Tier**

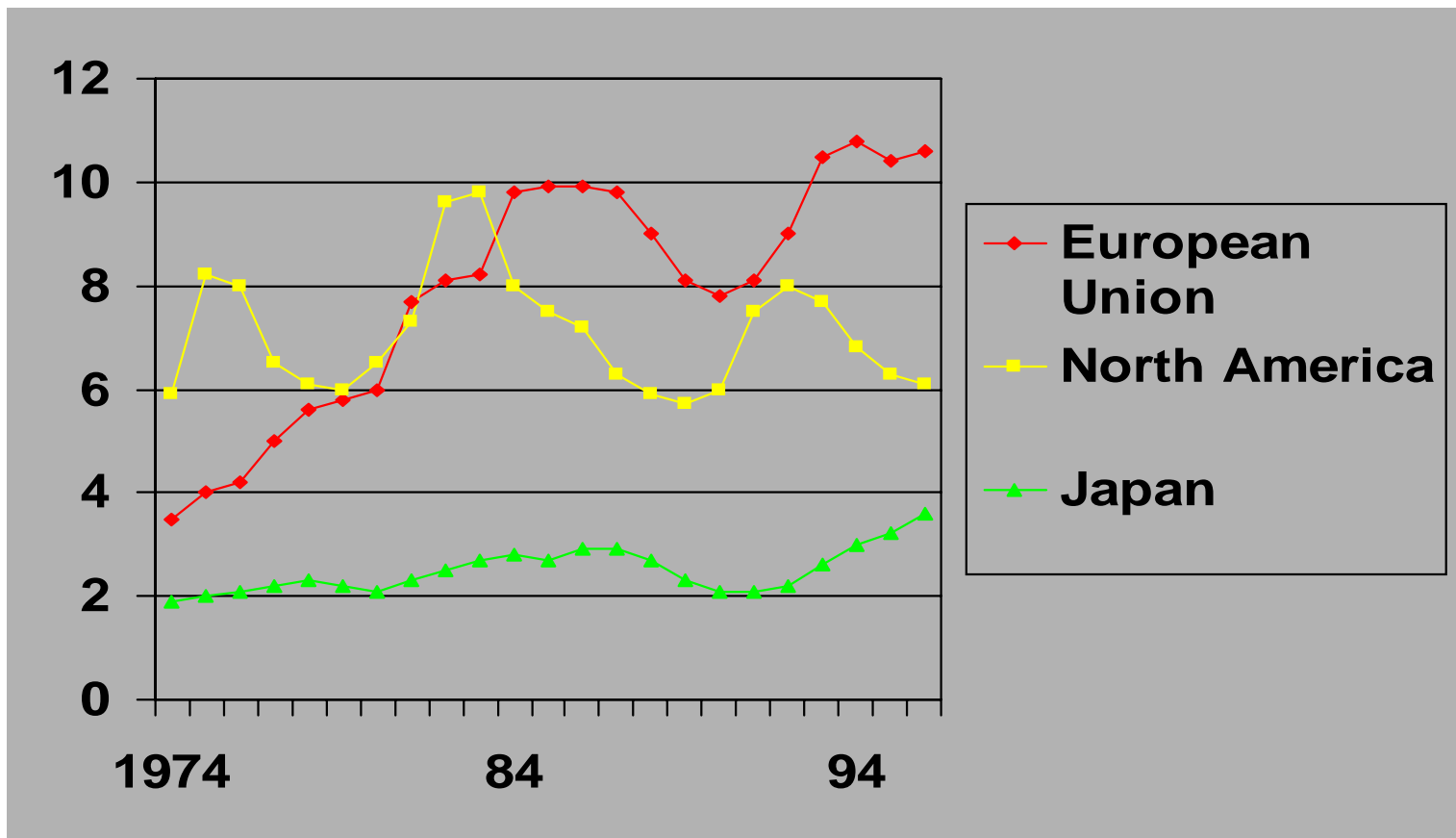
# Other Signs Much Less Positive

- **Due To Interest & Growth Rate Differentials, Has Been A Weak Currency Vs. Dollar**
  - But Also Weak Versus £ And ¥
  - Good For Exports, Bad For Investor Confidence
- **Differential Growth Rates In EU Troubling**
  - Periphery Growing Fast, Core Barely Growing
  - Monetary Policy Set By Core, Bad For Others
- **UK, Switzerland Outside By Choice**
- **Flawed Nature Of EU, ECB Decision-Making**
- **Structural Nature Of EU Economic Problems**

# Europe Has Long-Term Growth, Competitiveness Problems

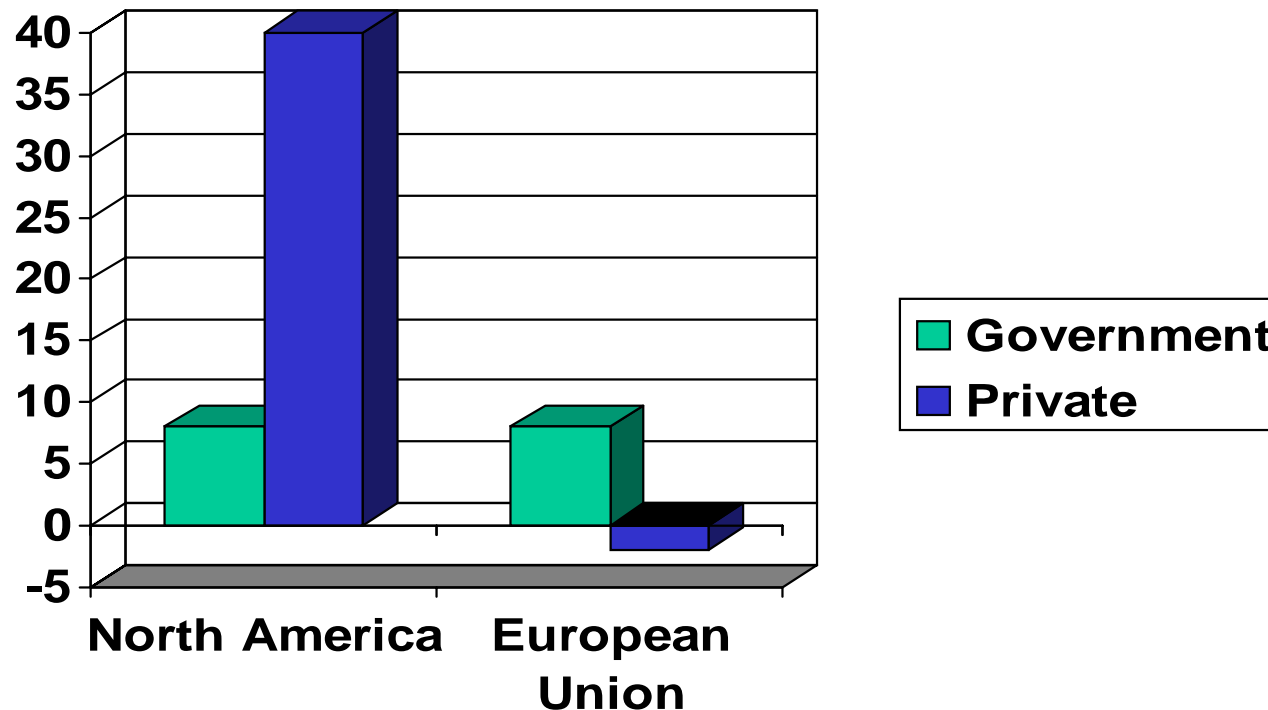
- **Several Core Competitiveness Problems**
  - Excessive Regulation Of All Markets
  - Unemployment, Total Lack of Job Creation
  - Noncompetitive Tax, Welfare Regimes
  - Relatively Weak Capital Markets
  - Technology Lagging U.S., Japan
  - Pay As You Go Pension Systems
  - Very Slow Population Growth

# Europe's Unemployment Rate



# Job Creation: Europe's Great Economic Failing

Estimated Change 1970-94, Millions



# Weak Capital Markets: Europe's Great Financial Failing

## Private Pension Financing, 1994

	\$ Bn	% of GDP
Spain	11	2
Italy	23	2
France	50	4
Germany	111	6
USA	4,527	67

# Europe's Fiscal Time Bomb: Unfunded Pension Liabilities

As % of GDP	Net Public Debt, End 1994	Net Pension Liability, 1995-2050
France	42.4	113.6
Germany	52.5	110.7
Italy	112.9	75.5
Japan	33.2	106.8
USA	63.3	25.7
UK	37.7	4.6

# Europe's Technology Gap

	Europe	U.S.
Business With Internet Access	47%	61%
Households With Internet Access	5.5%	18%
Total Spending On Info Technology	\$196 bn	\$320 bn
Total Spending on Telecom Services	\$182 bn	\$230 bn
Households With Personal Computers	24%	46%

# **In Spite Of Problems, Euro's Long-Term Outlook Is Positive**

- **Europe Has Formidable Economic Strengths**
  - Economy Comparable To US, Larger Population
  - Higher Share Of World Trade (15% Vs 12%)
  - Much Higher Savings Rate Than US
- **US Running Persistent Current Account Deficits**
- **Diversification Of World Reserves Favors Euro**
- **Euro's Launch Likely To Promote Reforms**
  - Will Foster Great Price Transparency, Competition
- **Capital Markets Likely To Grow Fast To “Catch Up”**

# **Topic 8:**

## **The Increasing Importance of Mergers & Acquisitions To The Global IB Industry**

# What A Year!

- **1998 Broke All Records For M&A**
- **\$2.51 Trillion In Announced Deals Worldwide**
  - 54% Higher Than 1997's Level (Previous Record)
  - \$2.09 Trillion In Completed Deals
- **\$1.63 Trillion In US Announced Deals**
  - 79% Higher Than 1997's Record Level
  - \$1.32 Trillion In Completed Deals
- **Hugely Profitable For Investment Bankers**
  - Total Disclosed Fees In US \$2.68 Billion

# The Role Of Investment Bankers In M&A Transactions

- **Both Bidder & Targets Use IBs**
  - Provide Advice, Certification, Even Financing
- **Often Brought In To *Initiate* Takeovers**
  - Firm Wishing To Be Acquired Can Use IB
  - Prospective Acquirers Use IBs To Shop
  - Both Parties Seeking Contacts, Advice, Discretion
- **Always Brought In Once Bid Is Underway**
  - Especially Important In Contested Bids
  - Extremely Important Role In Valuation

# The Role Of Investment Bankers In M&A Transactions (Cont.)

- **Roles Differ In Cash Versus Stock Mergers**
  - Cash Deals: Financial, Strategic Advice
  - Stock Deals: Legal, Regulatory, Governance Advice; More Complicated, Longer Process
  - Cross-Border Deals Usually Pay With Cash
- **Roles Differ In Friendly Versus Hostile Mergers**
  - Vast Majority Of M&As Are Friendly
  - IBs Help Arrange, Sell Deal To S/Hs, Regulators
  - In Hostile Deals, Play Strategic Role, Find White Knights

# M&A Becoming Increasingly International

- **Cross-Border Deals Now One-Quarter Of Total**
  - \$685 Bn In 1998 Versus \$399 Bn In 1997
  - \$292 Bn Of These Involved European Targets
  - \$247 Bn Involved US Targets
- **Total Deals With European Targets \$529 Bn 1998**
  - Involves Both Intra-National, Cross-Border Deals
  - Biggest Deal Of 1998: ZENECA/Astra (\$34Bn)
  - Two Mega-Mergers So far In 1999
- **Europeans Largest Intl Acquirers Of US Firms**
  - UK, Germany, Canada, France, Netherlands

# **Even In European M&A, However, US Banks Dominate**

<b><u>Financial Adviser</u></b>	<b><u>Value Announced Deals</u></b>
<b>Morgan Stanley Dean Witter</b>	<b>\$174 Bn</b>
<b>Goldman, Sachs</b>	<b>\$173 Bn</b>
<b>Credit Suisse First Boston</b>	<b>\$101 Bn</b>
<b>Merrill Lynch</b>	<b>\$81 Bn</b>
<b>J.P. Morgan</b>	<b>\$79 Bn</b>
<b>Warburg Dillon Read</b>	<b>\$78 Bn</b>

# **In US: Goldman Sachs Out Front, Pulling Away**

<b><u>Financial Adviser</u></b>	<b><u>Value Announced Deals</u></b>
<b>Goldman, Sachs</b>	<b>\$756 Bn</b>
<b>Merrill Lynch</b>	<b>\$520 Bn</b>
<b>Salomon Smith Barney</b>	<b>\$430 Bn</b>
<b>Morgan Stanley Dean Witter</b>	<b>\$417 Bn</b>
<b>Credit Suisse First Boston</b>	<b>\$298 Bn</b>
<b>J.P. Morgan</b>	<b>\$214 Bn</b>

# 1998 Saw Largest Announced Mergers In US History

<u>Target Name</u>	<u>Bidder Name</u>	<u>Deal Value</u>
Mobil	Exxon	\$79 Bn
Citicorp	Travelers	\$73 Bn
Ameritech	SBC Communicat	\$63 Bn
BankAmerica	NationsBank	\$62 Bn
TCI	AT&T	\$53 Bn
GTE	Bell Atlantic	\$53 Bn
Amoco	British Petroleum	\$48 Bn
Chrysler	Daimler-Benz	\$40 Bn

# 1999 Shaping Up As Another Good Year, Particularly In Europe

- **Two Colossal Mergers Underway In EU**
  - BNP Vs Societe Generale, Paribas In France
  - Olivetti Vs. Telecom Italia, Deutsche Telecom
  - Five Of Six Contestants Are Privatized Firms
- **EU Integration, Competition Driving Mergers**
  - Search For Scale & Synergies
  - Synergies Hard To Achieve If Staff Cuts Required
- **Large Cross-Border Mergers Still Quite Rare**
  - Hostile Cross-Border Deals Non-Existent

# **Topic 9:**

## **American Investment Banking Characteristics And Industry Practices**

# **Finance In America: An Enormous Industry**

- **Finance Accounts For 11% Of US GDP**
- **In NYC Alone, Brokerage Firms Employ 250K+**
- **Financial Markets Play A Large Role In US Life**
  - Only Rivalled In Impact By Switzerland, UK
  - Pension Fund Assets Now \$6.4 Trillion
  - 25% Of Americans Own Stock Directly
  - Half Own Stock Directly Or Thru Pension Funds
  - Stock Mkt “Wealth Effect” Has Fueled Spending
  - Entrepreneurship Key Part Of US Culture
  - “The Business Of America Is Business”

# **US Investment Banking Provides Many Retail Services**

- **Retail Brokerage Business Unusually Important**
  - Merrill Lynch Pioneered After WWII
  - Over 5,000 Mutual Funds Available
- **Asset Management A Large & Growing Business**
  - IBs Compete With Specialized Asset Managers
  - Fidelity, Vanguard Family Of Funds
- **Provide Trust, Custodial Services**
  - Compete With Commercial Bank Trust Depts
- **Money Market Mutual Funds, CMAs Have Been Enormously Successful**

# **Will Concentrate On Services Provided To Corporations**

- **Provide Advice To Firms On Financing, M&A**
- **Provide Risk Management, Hedging Tools**
- **Help Private Firms Go Public (Next Topic)**
- **Help Public Firms Go Private (LBOs)**
- **Offer Merchant Banking Services, Venture Capital**
- **Arrange Private Financing (Private Placements)**
- **Guide Issuing Firms Through Regulatory Process**
- **Underwrite Security Offerings**
  - The Focus Of This Topic

# Many Types Of Securities Sold On US Capital Markets

- **Short & Intermediate Term Debt Securities**
  - Treasury Bills: Sold Directly By Govt
  - Commercial Paper: 270 Day Maturity Or Less
  - Medium-Term Notes: Floating & Fixed Rate
  - Asset-Backed Securities: Credit Card, Car Loans
- **Long-Term Government Securities**
  - Treasury Notes & Bonds: Looming “Shortage”
  - “Agency Securities”: Backed Implicitly Or Explicitly By US Government
  - Municipal Sec: Revenue & General Obligation

# Many Types Of Securities Sold On US Markets (Cont.)

- **Long-Term Corporate Debt Securities**
  - Mortgage Bonds, Equipment Trust Receipts
  - Corporate Debentures
  - High-Yield Debt (Junk Bonds)
  - Collateralized Securities: MBS, ABS
  - Convertible Debt
- **Equity Securities**
  - Preferred Stock: Convertible & Nonconvertible
  - Common Stock: Seasoned & Unseasoned

# Many Types Of Underwritings Observed In US

- **Best Efforts Versus Firm Commitment**
  - Most Issues Are Firm Commitments
- **Competitive Versus Negotiated Underwriting**
  - Negotiated Used Unless Competitive Required
- **Rights Offering Versus General Cash Offer**
  - Unlike EU, Rights Offering Rare In US
- **Private Placement Versus Registered Public Offer**
  - Spectrum Of Privates: LPs, True PP, Rule 144A
  - Three Levels Of ADRs For Non-US Issuers
  - Shelf Versus Traditional Registered Offer

# Overview Of The Registration Process

- **All Securities Offered For Public Sale Must Be Registered & Approved By SEC (SEC Act of 1934)**
- **Disclosure Procedures Detailed In Securities Act**
  - Most Security Offerings Must Use Form S-1
  - S-1 Requires 3 Yrs Audited Data, Reg S-X Acctg
  - Smaller Firms (<\$25 Mn Rev) Can Use Form SB-2
  - Requires 2 Yrs Data, Prepared Using GAAP
- **Registration Statement The Disclosure Document**
  - 2 Parts: Prospectus & Supplemental Disclosures
  - Prospectus Given To Prospective Investors

# Steps Involved In Registration Process

- **First Step In Process: Filing With SEC**
  - Preliminary Prospectus Can Be Shown Publicly
  - Called “Red Herring,” No Binding Sales
  - Firm & Advisers Now Often Mount “Road Show”
- **After SEC Responds, Firm Revises & Refiles**
  - Multiple Rounds Of Prospectus Printings
  - IB Building Book To Assess Demand, Set Price
- **Once SEC Approves, Offer Becomes “Effective”**
  - Can Legally Proceed With Public Sale
  - Price Set, Final Printings, Sale & Listing

# Who Leads In US Underwriting? Round Up The Usual Suspects

<u>Lead Manager</u>	<u>Value All Deals</u>	<u># Offers Lead</u>
Merrill Lynch	\$304 Bn	2,212
Salomon Smith Barney	\$224 Bn	1,242
Morgan Stanley Dean Witter	\$204 Bn	1,696
Goldman, Sachs	\$192 Bn	1,051
Lehman Brothers	\$147 Bn	803
Credit Suisse First Boston	\$129 Bn	886

# **Topic 10:**

## **Venture Capital And Initial Public Offerings In The United States**

# Entrepreneurial Finance In The US

- **Entrepreneurial Tradition & Financing Techniques Considered A Key US Comparative Advantage**
- **Many Sources Of Start-Up, Expansion Capital**
  - Angel Capitalists, Venture Capital, SBIR Grants
  - Most Start-Ups Are Self-Funded, As Elsewhere
  - Many Institutional Sources Of Expansion Capital
  - Emphasis On Private Capital, Though Govt Helps
- **Key Difference With Other Countries: Easy Access To Public Capital Markets**
- **Venture Capital & IPOs The Focus Here**

# What Is A Venture Capitalist?

- **Can Be Defined Many Ways**
- **Will Use: “A Professional Investor Who Provides Capital & Expertise To Private Entrepreneurial Growth Companies, Who Expects To Earn Super-Normal Returns, And Who Has A Well-Defined Exit Strategy.”**
- **Focus On Institutional Venture Capitalists**
  - Most Are Organized As Limited Partnerships
  - Most Are Concentrated In California, Boston, NYC

# History Of Venture Capital In The US

- **Pre-Modern VC Associated With Wealthy Families**
  - Rockefeller Family Fund, Venrock Associates
- **First Formal VC Fund: American Research & Development Company**
  - Founded In NYC After WWII
- **Until 1978, VC Small, Often Bank-Related**
- **Fundamental Change Began In 1978**
  - Congress Lowered Capital Gains Tax To 28%
  - Labor Dept Relaxed “Prudent Man Rule” Opened VC Up To Pension Funds

# History Of Venture Capital In The US (Cont.)

- **Growth Took Off In 1980s**
  - 1981 Congress Lowered Tax Rate Again, To 20%
  - Total VC Funding Jumped To \$5 Bn In 1983
  - Stayed In \$2-5 Bn Range Through 1980s
  - Vibrant IPO Market Offered Exit Vehicle
- **Dropped Sharply After 1987 Market Break**
  - IPO Market Depressed For Several Years
  - VC Commitments Slumped To \$1.3 Bn In 1991
- **VC & IPO Markets Have Both Soared In 1990s**

# Types Of Venture Capital Funds

- **Four Basic Categories:**
  - Small Business Investment Companies
  - Financial Venture Capital Funds
  - Corporate Venture Capital Funds
  - Venture Capital Limited Partnerships
- **VCLP By Far The Most Successful Type**
  - VC Firm The General Partner, Many LPs
  - Fund Structured To Have 7-10 Year Life
  - Expect To Earn 30-50% Compound Annual Return
  - Tend To Specialize By Industry

# How Venture Capitalists Structure Investments

- **Almost Always Use Convertible Preferred Stock**
  - Would Have To Purchase Majority If CS Used
  - Legally Risky To Use Debt If Significant Control
  - CPS Junior To Debt, Senior To CS (Entrepreneur)
  - Able To Write Positive & Negative Covenants
  - Usually Convert Into CS Prior To IPO
- **Structured To Focus Business Risk, Incentives**
  - Entrepreneur Bears Most Risk, But Can Benefit
  - VC Usually Has Right To Remove Entrepreneur

# Overview Of VC Funding & Investment

- **VC Funding & Disbursement Has Grown In 90s**
  - Record Total Investments Of \$12.5 Bn In 1998
  - 12.5% Increase Over 1997's Record \$11.2 Bn
  - 1,824 Transactions In 1998 Vs. 1,821 In 1997
  - Q1 1999 Saw Record \$3.59 Bn Financing
- **Information Technology Garnered Most Funding**
  - 60% Of Financings, 62% Of Dollars Invested in 98
  - Internet Investments Received 40% Of 98 Funding
  - Internet Share Reached 58% Of Q1 99 Funding

# Most Active Venture Capital Investors In 1998

<u>Investor</u>	<u># Of Deals</u>
New Enterprise Associates	70
Kleiner Perkins Caufield & Byers	61
Institutional Venture Partners	55
Mayfield Fund	53
Accel Partners	50

# Exit Strategies For Venture Capitalists

- **Three Basic Exit Strategies:**
  - Initial Public Offering, Usually Preferred Option
  - Acquisition Of P/F Company By Larger Firm
  - Buy-Out By Founder Or Liquidation For Failures
- **Fewer, But More Valuable IPOs Recently**
  - Number Of IPOs Fell Again in 98 To 77 From 135
  - Value \$4.2 Bn (\$54m Avg) Vs \$5.4 Bn (\$40m) 97
- **VCs Usually Retain Stock After IPOs**
  - Usually Don't Sell Any In IPO, Rarely Sell 100%
  - Tend To Sell Out Over Time

# How Successful Have Venture Capitalists Been?

- **Hard To Measure Actual Return Accurately**
  - Self Reporting Bias, Many Non-Public Investments
- **Measured Returns Highly Cyclical**
  - High Now & Late 80s, Low In Early 90s
- **Still, Much Higher Than Mutual Funds, Market**
- **VC Involved In Almost All Recent Success Stories**
  - Apple, Federal Express, Compaq, Microsoft, Sun, Intel, Amgen, Cisco, Genentech In 70s & 80s
  - Amazon.com, eBay, Yahoo, Lycos, America Online Today

# Overview Of US IPO Market

- **Historically Very Active In Us, Though Cyclical**
- **13,910 Offerings During 1960-97 Period Raised \$331 Billion**
- **395 Offerings Worth \$43.7 Billion In 1998**
- **IPOs Usually Account For 30-45% Of All Common Stock Offerings Each Year**
- **Concentrated In High-Tech, But Also Open To Any Private Business Wishing To Go Public**
- **After IPO, Stock Listed On NASDAQ Or NYSE**
- **Ongoing Responsibilities Of Public Company**

# What Returns Do Investors Earn On IPOs?

- **Initial (First Day) Returns Generally Very Good**
  - Average 15.7% Over 1960-97 Period & In 90s
  - Can Exceed 100% For “Hot Issues”
  - Internet Stocks Spectacular Performers
- **Longer-Term Record Much More Mixed**
  - In US, AS In Most Countries, L-R Return Negative
  - Under-Perform Market By 40% Over Three Years
  - Venture-Capital Backed IPOs Do Better L-Term
  - Open Question: Why Do Investors Keep Coming Back Year After Year?

# Who Leads In IPO Underwriting? Who Do You Think?

<u>Underwriter</u>	<u>Value, All Deals</u>	<u># Offers Lead</u>
Merrill Lynch	\$9.6 Bn	30
Morgan Stanley Dean Witter	\$9.5 Bn	24
Salomon Smith Barney	\$3.5 Bn	26
Goldman, Sachs	\$3.4 Bn	26
Credit Suisse First Boston	\$1.9 Bn	15
Paine Webber	\$1.7 Bn	5

# **A Look Ahead**

**How Will Investment Banking  
Be Practiced In The 21st  
Century?**

# **Trends & Forces Driving International IB Industry Today**

- **The Impact Of Information Technology & Telecommunications On Investment Banking**
- **Deregulation, Privatization, and The Growth of Private Infrastructure Financing**
- **The Rise of Funded Pension Systems**
- **Dueling Currencies: Dollarization and The Growth of Euro Zone Capital Markets**
- **The Continuing Rise Of The Bulge Bracket**
- **Are Financial Groups The Wave Of The Future?**