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The Role of Investment Banks in Financing

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the role of underwriters and market makers. Specifically, this lesson will cover:

1. Underwriter

Underwriting refers to the process that a large financial service provider (bank, insurer, or investment house) uses to assess the eligibility of a customer to receive their products (equity capital, insurance, mortgage, or credit). **Underwriters** exist in a number of different industries and are primarily responsible for evaluating the risk of potential clients.

In investment banking, underwriters are best known for the role that they play in initial public offerings (IPOs). IPOs are when a company decides to sell equity on the stock market for the first time. They sell their own stock on the market and in the process, raise money through selling equity. However, investment banks are involved in the underwriting of all types of **securities**, not just stock.

The company needs to set a price for its stock and they want to set it high enough to raise as much money as possible but low enough that they will be able to sell their stock. Thus, there is a risk to the company in the offering of securities. For all types of securities, whether offered by companies or the government, there is a risk that the **issuer** may not be able to have a successful securities offering.

That is where the job of the security underwriter comes in. The underwriter offers to take on some of the risk of the offering in exchange for a premium. In essence, the underwriter buys the securities from the issuer and then turns around to sell the securities on the market. This means that the issuer gets cash upfront. The issuer knows that it is probably not getting the full market value of the securities, but that's okay because it no longer has the risk of having to find enough buyers to purchase the securities at a desirable price. The underwriting investment bank likes the deal because if it can sell the securities on the market at a higher price than it purchased them, it can make a profit.

BIG IDEA

There are sometimes multiple investment banks involved in the underwriting of a security. The details of the process may vary from deal to deal, but the fundamental job of the underwriter(s) is to take some of the issuer's risk in exchange for a premium.

TERMS TO KNOW

Underwriter
Buys securities from the issuer and then sells it on the market.

Security
Proof of ownership of stocks, bonds, or other investment instruments.

Issuer
The firm or government selling the security.

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2. Market Maker

The price of a stock is determined through a simple process of matching buyers and sellers. All those who want to sell the stock say the price at which they are willing to sell a certain number of shares, also known as the **ask price**. All those who want to buy say the maximum price they're willing to pay for a certain number of shares, or the **bid**. The difference between the highest bid and the lowest ask price is called the**bid-ask spread**. If one person's bid equals another's ask price, they have found a price at which they are both willing to do business, and the transaction occurs. The mutually agreeable price is then inputted as the stock price.

IN CONTEXT

Consider the following prices for gold.

New York Spot Price

MARKET IS OPEN
(Will close in 3 hrs. 42 mins.)

Metals	Date	Time (EST)	Bid	Ask	Change		Low	High
GOLD	10/27/2008	13:33	742.30	743.30	+8.00	+1.09%	713.10	746.90
SILVER	10/27/2008	13:33	9.19	9.22	-0.18	-1.92%	8.81	9.29
PLATINUM	10/27/2008	13:30	785.00	795.00	-9.00	-1.13%	739.00	796.00
PALLADIUM	10/27/2008	13:33	170.00	180.00	+2.00	+1.19%	165.00	181.00

The highest price someone is willing to pay (bid) for gold is $742.30 and the lowest someone is willing to accept (ask) is $743.30. There is a bid-ask spread of $1.00.

In major stock exchanges, such as the New York Stock Exchange, there are enough people who want to buy or sell at any given time that it's generally easy to find someone to transact with if you're making a bid or ask near the last price. This is called liquidity.

But what happens if there is no liquidity? Since there aren't very many people looking to trade the stock, the highest bid may be significantly lower than the lowest ask price, so no transactions occur. A lack of liquidity is quite bad for investors. If they don't think they can buy or sell the stock when they need to, they will choose to just not deal with it.

That is where a special type of trader called market makers comes in.**Market makers** are a company or individual that quotes both an ask price and a bid. This helps to provide liquidity to the market, making the market more efficient. For this reason, many exchanges, such as the New York Stock Exchange and American Stock Exchange, have designated market makers for certain securities.

The financial reason why market makers do this is that the ask price that they submit will always be slightly higher than their bid. It is the bid-ask spread that provides the money-making opportunity. A bid-ask spread of even a cent can mean a huge profit when trading thousands of shares.

TERMS TO KNOW

Ask Price
The submitted price at which the trader is willing to sell.

Bid
The submitted price at which the trader is willing to buy.

Bid-Ask Spread
The difference between the prices quoted for an immediate sale and an immediate purchase.

Market Maker
A company or individual that submits both an ask price and a bid on a security.

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3. Advisor

Investment banks also play the role of advisor to companies. They are not consultants, but are more like facilitators. The advisory group in an investment bank is often termed **mergers and acquisitions (M&A)**. M&A refers to the the buying, selling, dividing, and combining of different firms.

> EXAMPLE If a company wants to sell off an unprofitable division, they will hire an investment bank to find a company that would want to buy it.

Investment banks play a large role in facilitating M&A deals. The advisory group is charged with the task of helping buyers find sellers and vice versa, and then facilitating the deal.

Once the advisory group is hired by a company looking to sell itself to another, it will put together something called a pitch book. The pitch book contains all the relevant financial information about the company looking to get acquired. The investment bank then takes the pitch book to companies that it thinks might be interested in acquiring their client.

If the pitch is successful, the bank arranges the deal for the client. In order for the acquisition to take place, the two boards and leadership must agree on the terms. This is often a very complex process because of the intricacies of the financial, functional, and organizational structures of both companies. There must be a plan for transferring everything from technology to debt to employees to titles, and the transaction must occur at a favorable price. If the negotiations are successful, the investment bank's client will be acquired.

TERM TO KNOW

Mergers and Acquisitions (M&A)
Aspects of corporate strategy, corporate finance, and management dealing with the buying, selling, dividing, and combining of different companies and similar entities that can help an enterprise grow rapidly in its sector or location of origin, or a new field or new location, without creating a subsidiary, other child entity or using a joint venture.

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4. Agency

Investment banks are not confined solely to working with and making money on large, publicly traded companies. They also can be hired by private firms. A private firm might hire an investment bank for help with a merger or acquisition or for issuing an IPO. A private firm might also hire an investment bank as a placement agent.

BIG IDEA

In its agency role, an investment bank is tasked with matching companies with investors.

Suppose a firm does not want to be acquired and cannot, or does not want to, get good loans from banks. They still need to raise capital, but can't access public markets, such as the stock market; they have to find different ways to raise capital. They hire a placement agent to act as an intermediary between them and investors. This allows them not only to connect with investors but also allows them to focus on management, instead of finding investors.

Capital financing for private companies can come from a number of sources. Three of the main capital sources are:

- *Equity financing:* Private firms can sell some or all of their equity to investors. This is akin to selling off a portion of the ownership of the company. It may seem undesirable to sell a portion of the company's ownership, but many firms (especially start-ups and growth companies) need to do so for immediate capital to fund future growth.
- *Mezzanine capital:* A subordinated debt or preferred equity instrument that represents a claim on a company's assets, which is senior only to that of the common shares. Mezzanine financings can be structured either as debt (typically an unsecured and subordinated note) or preferred stock.
- *Specialist financing:* This could include things such as government loans or special grants that the company qualifies for.

Placement agents are most often compensated through fee arrangements based on the amount of money raised and supported by the fund or company they are representing.

SUMMARY

In this lesson, you learned about the various roles that investment banks play to assist companies with their long-term financing needs. Investment banks often function as securities **underwriters** who manage IPOs for companies ready to go public. **Market makers** provide liquidity to markets by providing both an ask price and a bid on securities. Investment banks may also function as **advisors** to companies seeking or undergoing a merger or acquisition, or as **agencies** if they're hired by a private company to help connect them with other capital sources.

Best of luck in your learning!

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