What is investment Banking

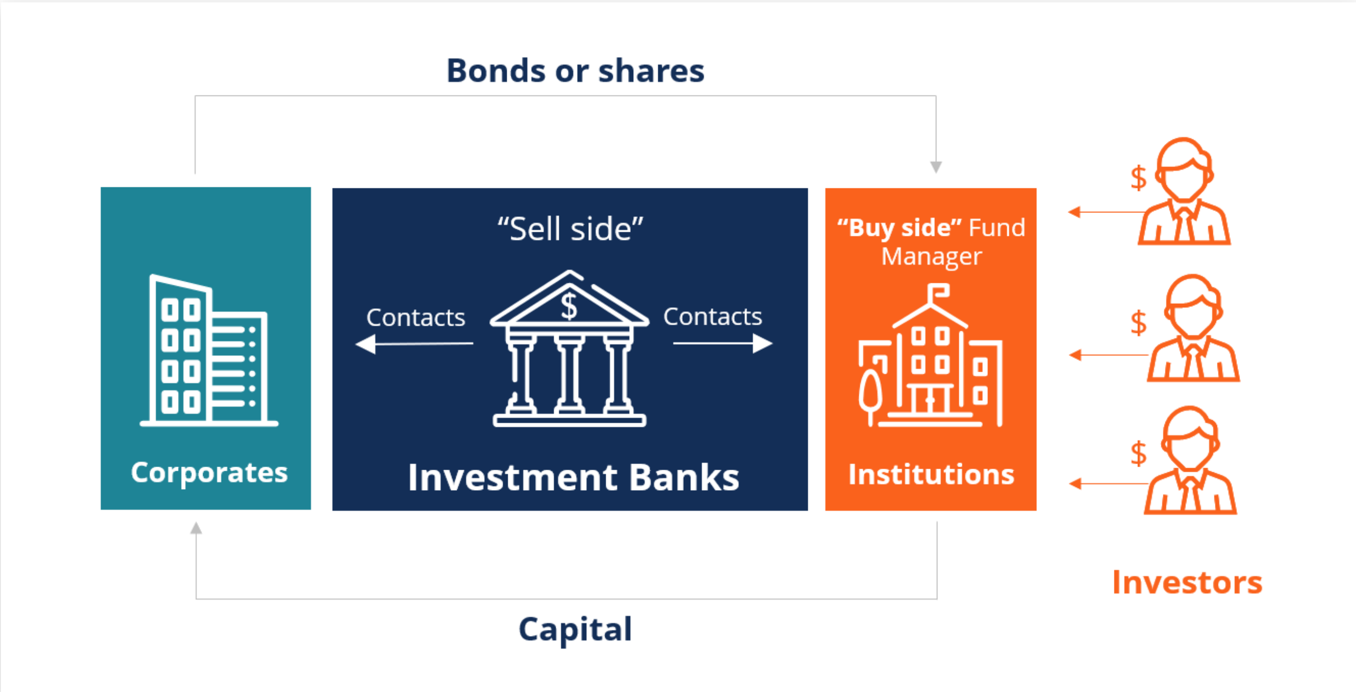
- Investment Banking is a form of financial intermediation
  - What is financial intermediation?
  - How are investment banks different from commercial banks?
  - Do they engage in maturity transformation?

- Potential Investors in real assets are long in ideas (about generating cash/projects) but short in cash
  - Investment banks channel funds between agents with surplus funds to the investors

- Invest Banks explore opportunities to unlock the value of ‘ideas’, create ‘businesses’
  - They route the money in a way that changes the status of money – from being idle to having productive purpose

- Investment banks leave at the end of transaction
  - Charges a fee for their services
  - This feature is unlike the commercial banks

Investment Banks: Mechanism of operation



Portfolio of Services

- Capital Raising
  - Generate money from Investors
    - Helps in issuing bonds and stocks
- Financial Advisory
  - Helps firms and governments to manage financial resources
  - Help in decisions to buy/sell a company or its parts (M&A)
- Corporate Lending/Syndication
  - Helps to raise loans or float bonds
  - Helps in arranging Bridge Loans

Portfolio of Services

- Helps in buying securities and/or financial reengineered products
  - Securities from Markets or Private Placement
  - Products for hedging risk
- Brokerage Services
  - Holds assets on behalf on clients
  - Helps in trading
- Research
  - Global market, domestic market
  - Outlook – long term and short term
- Investing in Private Equity through own funds
  - Investment banks use their own funds to purchase private equity

Underwriting of Securities

- An important function performed by Investment Banks
- Underwriting – applicable for both stocks and bonds
- Underwriting is the process where an Investment bank has a commitment to buy/sell a capital market market instrument
  - The commitment is provided to a client (corporation, institution, or government)
  - IPO/NFO follows the underwriting process
- Should the instrument not able to float in the market, the investment bank commits to buy/sell the security
  - Underwriting provides a comport to the retail and other institutional investors
  - Underwriting also provides a comfort to the issuer/buyer of the security

Underwriting Advisory Services

- Consists of 3 basic stages
  - Planning
  - Timing and Demand
  - Issue Structure

- Planning: Key Questions
  - Why does the issuer want to invest? – Is the investment rational?
  - Are the buyers of the issue convinced about the investment ideas – will the issue float?

- Timing and Demand (for the issue)
  - Current market condition: Hot or a cold issue market?
  - Current investor appetite: What is the current investor risk profile and appetite? Is it aggressive or conservative? Are investors risk preferring, neutral, or averse?
  - Precedents and benchmark offerings: Has a similar company (based on size, industry, and geographical location) issued an IPO in the past? What are some other companies that you can benchmark for an IPO?
  - Current news flow: What is the current news flow on the company? Is it a positive or a negative flow?

Underwriting Advisory Services...Contd.

- Issue Structure
  - Final phase of underwriting process
  - Decides on the structure of the issue
- Key Questions in Issue Structure
  - Is it going to be a domestic or an international issue? Are the investor demands located domestically or overseas? Would investors from other countries be interested in this offering?
  - Is the focus on institutional or retail investors?
  - How will the sale occur?

Types of Underwriting Commitment

- Firm Commitment
  - Underwriter agrees to buy the entire issue at a certain price
  - If the issue fails (wholly or partially), the underwriter must buy the unsold part
  - There is a financial guarantee from the underwriter
- Best Effort
  - Most common form of underwriting
  - Underwriter provides a guarantee to sell the issue as much as possible – will take best effort to float the issue
  - Does not take any financial responsibility for the unsold part, if any
- All-or-None
  - If the entire issue is not sold, the deal is cancelled
  - Underwriter does not get any consideration for underwriting

Structure of Investment Banking

- Front Office
  - Contacts investors (in need of money) and sells securities to those who want to buy
    - Responsible for Deal making
  - Pairs up Bidders and Targets in the case of M&A
  - Engages in “Proprietary Trading” (also called “frenetic trading”)
    - Proprietary trading is done in all markets taking advantages of overvaluation/undervaluation by markets
    - Done with complex mathematical models (Artificial Neural Networks)
    - Done for both clients and the investment bank themselves
  - Conducts research (about prospective investors, markets, industry, economy)
    - Some reports are published in the public domain

Structure of Investment Banking...Contd.

- Middle office
  - Conducts intense financial engineering
  - “Innovates” financial products and contracts
    - Examples: Auction Rate Securities, Credit Default Swaps, Credit Default Options, etc.
    - These derivative and hybrid products may be “weapons of mass destruction” (Buffet, 2015)

- Back Office
  - Really, absent from the public eye
  - Engages in developing computer programs for analyzing market feeds, forecasting, etc.
  - Engages in Big Data Analysis

Sources of Revenue

- Commissions
  - Brokerage for intermediating deals
- Underwriting fees
  - Commissions for underwriting + Profits on Sale of Securities in the Primary Market
- Trading Income
  - From Proprietary Trading
- Asset