MARKET INSIGHTS:
Investment Bankers: Are They Worth It?

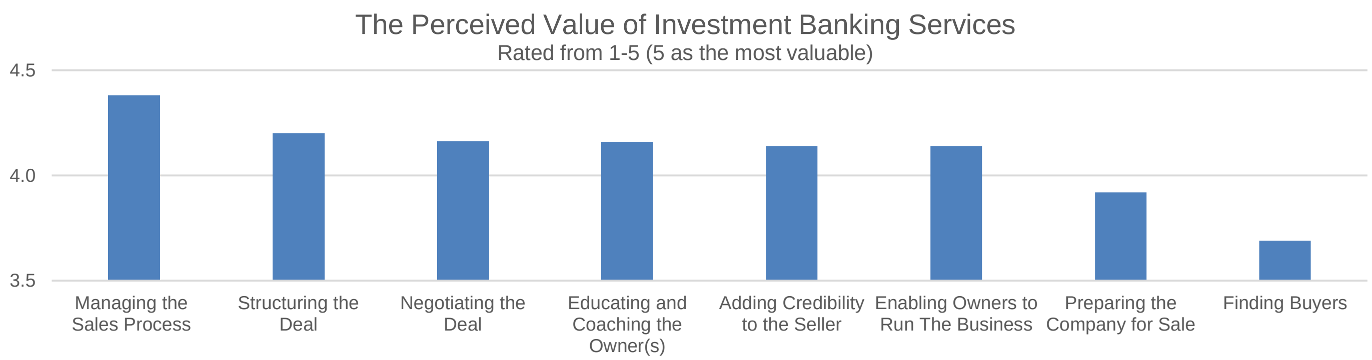
Q1 - 2017

Investment bankers from storied firms such as Goldman Sachs and JP Morgan often make headlines for the fees they generate. Most outside observers have a viscerally negative reaction to these large fees. How can those bankers possibly justify them? In other words, the question is: are bankers worth their cost?

That question is relevant to any company (and its ownership) that is considering an exit or a financing, not just those who hire the likes of Goldman Sachs. However, it had not been answered methodically for smaller, private companies in the middle market (evidence had been largely anecdotal to date), until Assistant Professor Michael McDonald at Fairfield University published a comprehensive analysis in October 2016. To answer that question, this edition of FirePower's *Market Insights* discusses findings from the study and draws from our own deal-making experience.

Findings from the study – How do investment bankers help and how is that perceived?

The Fairfield study surveyed 85 former business owners to evaluate their perception of the value of the services their investment bankers provided. To qualify and be a part of the study, business owners must have sold a majority stake in their businesses within the last 5 years at a purchase price between $10 - $250m, and were not backed by private equity. McDonald asked respondents to rank eight main services (i.e. the sources of perceived value) bankers provided as part of the sale; results were as follows:



McDonald categorized typical investment banking services in a clean and easy-to-understand manner for the surveyed respondents, which gives us significant confidence in the data:

1. **Managing the Sales Process:** Bankers are often "quarterbacks" for the entire deal, responsible for making the process competitive (this is critical: offers for middle-market firms can vary drastically in terms of price, structure, etc. because comparable deal information is scarce. Generating multiple offers is paramount in order to reduce the risk of a buyer acting opportunistically or heavy-handedly and, of course, to increase negotiating leverage), coordinating all aspects of the deal, managing a broad team of other advisors and moving the transaction towards closing (in particular, acting as an emotional and psychological buffer).
2. **Structuring the Deal:** Transactions can involve various forms of consideration, such as cash, equity, seller notes, earnouts and other forms of contingent consideration. Bankers structure each transaction specifically to address the needs and desires of both sellers and buyers, thus creating solutions for potentially conflicting transaction objectives.
3. **Negotiating the Deal:** Bankers typically take the lead in negotiating price, terms, conditions, timing, process and other considerations. Importantly, negotiations often rely on data from comparable transactions; sophisticated buyers are better equipped to win than middle-market sellers, *unless* the latter are represented by an investment bank. Separately, negotiations can get heated, but business owners often feel the need to be liked because they have to work with the buyer during the transition period post-close. Bankers can act as the 'bad cop' and handle the hard conversations.
4. **Educating and Coaching the Owner(s):** The vast majority of business owners have never closed a transaction. Seasoned investment bankers have managed hundreds of transactions and bring the benefits of that experience to the owner.
5. **Adding Credibility to the Seller:** Engaging an investment bank illustrates to all of the parties involved that there is a genuine commitment to explore the transaction and that there is professional representation, thus increasing the likelihood of a successful closing.
6. **Enabling Owners to Run the Business:** A sale is an intensive process for sellers to endure. By taking on most of the deal-related work, bankers enable operators to focus on growing their business rather than managing a deal.
7. **Preparing the Company for Sale:** Sellers are rarely ready for buyers' intense scrutiny. Bankers lead this groundwork (from preparing a confidential information memorandum and detailed financial models, to analyzing working capital price adjustments and buyer-specific synergies, to managing virtual data rooms with hundreds of due diligence items).
8. **Finding Buyers:** Bankers supplement the owners' knowledge of their industry and the potential partners in it by tapping into their contacts and networks, restricted-access databases, and technology and expertise to identify and connect with interested buyers.

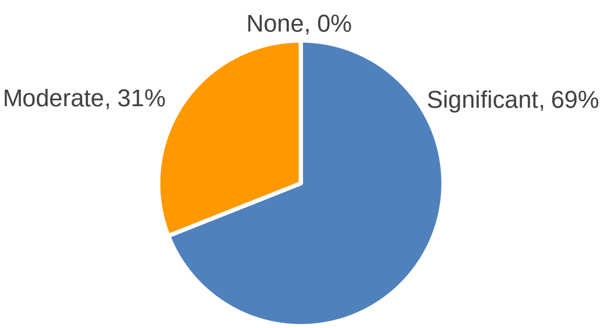
What is remarkable is that no one service was perceived as significantly less valuable than another. The difference between the most valuable service (Managing the Sales Process) and the least (Finding Buyers) is only 0.7 (out of 5), which tells us that bankers delivered value across their scope of work. This is an important point to make: because most owners have not concluded a deal before, they only realize what is needed from their investment bankers *after* the transaction is complete. And indeed, after the deal is done, owners see tremendous value in bankers' involvement as evidenced by this study.

Findings from the study (cont'd) – Were those value-added services worth the price paid for them?

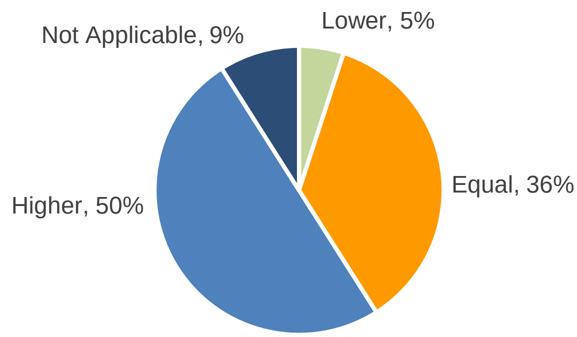
Yes, business owners found the services investment bankers provided to be valuable. The question of whether bankers were worth their cost still remains.

McDonald asked respondents the following question: "How much value did your investment bankers add?" which inherently factors in price. The results may be surprising to most business owners:

How Much Value Did Your Investment Banker Add?



A Follow-up Question: How Did Your Final Offer Compare With Your Investment Banker's Initial Valuation?



Granted, all respondents had successfully sold their businesses for more than US$10m, so their review of their investment bankers should be more positive than not. However, the data is clear: **no business owner thought the price they paid for their bankers was not commensurate with the value they received in exchange.** For them, engaging an investment bank leveled the playing field during their deals, which for most crystallized a lifetime of work and cemented their legacy.

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