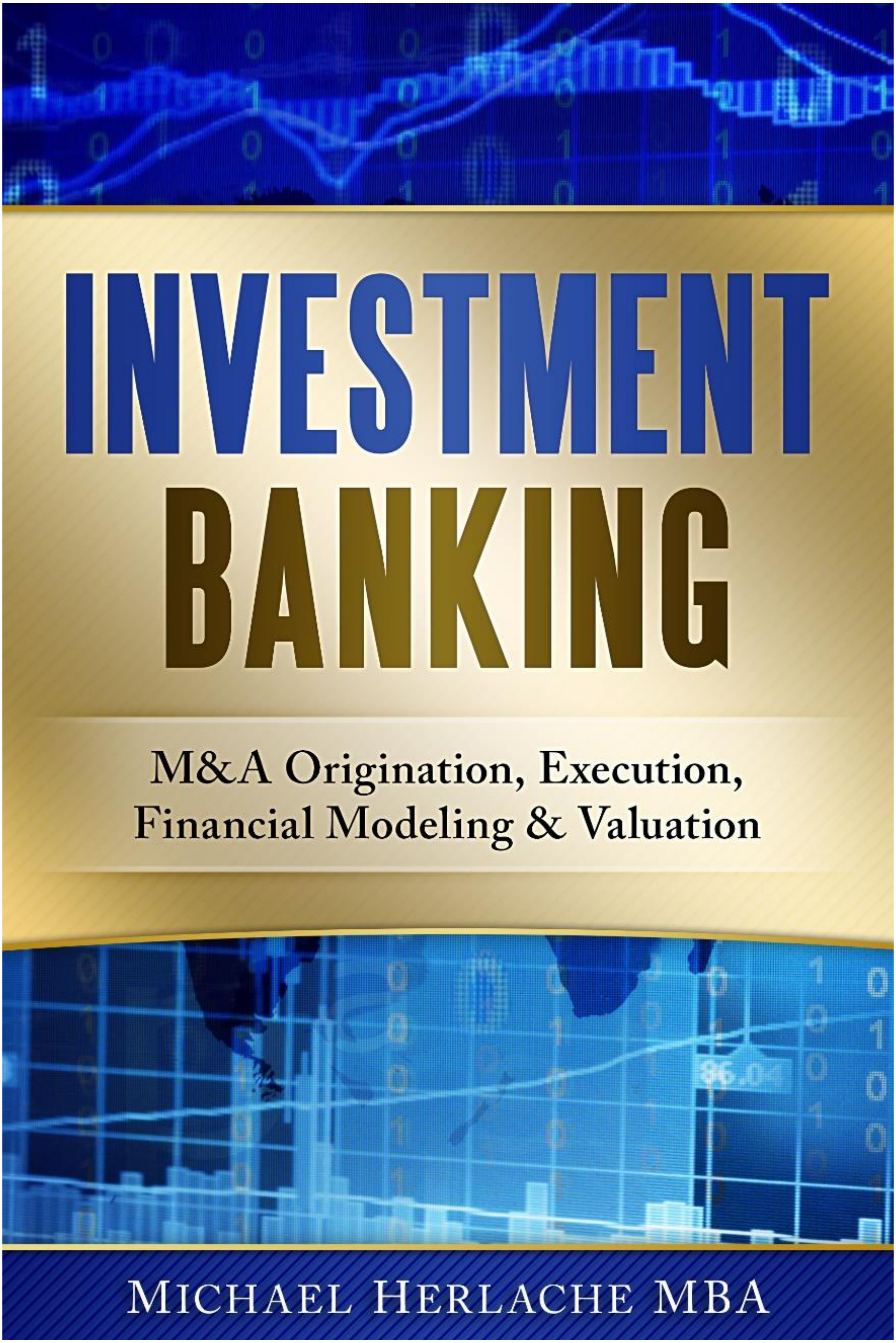
INVESTMENT
BANKING
M&A Origination, Execution,
Financial Modeling & Valuation
MICHAEL HERLACHE MBA

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Investment Banking System

Building a Middle Market M&A Practice

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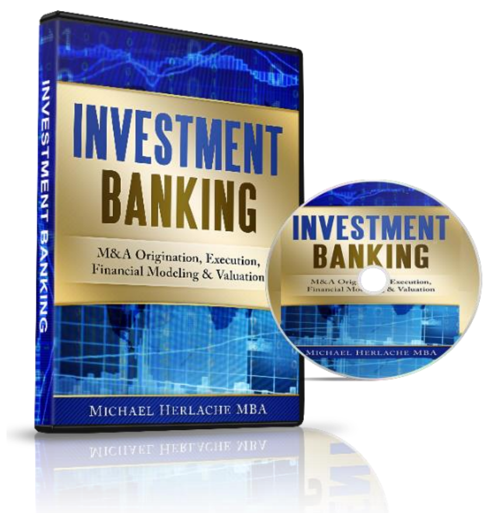
For my wife, Svitlana, whom is my treasure.

About the Author:

Michael Herlache is the Managing Director of M&A at AltQuest Group, a lower middle market boutique investment bank located in Wisconsin. He lives in his home in Wisconsin with his wife, Svitlana. Michael has an MBA in finance from Texas A&M University and is getting his Doctorate in Business Administration with a focus on finance. To learn more about AltQuest Group, please go to www.AltQuest.com.

For those interested in going through a formal investment banking training program associated with this text, the Investment Banking University (www.InvestmentBankingU.com) course's syllabus is based upon the content of this book.



Contents

Preface

There are many investment banking texts out there that claim that financial modeling and valuation is the core work of the investment banker. This is simply not the truth. The core work of the investment banker is origination, mandate/target matching, and deal structuring. It should follow that a text/course on investment banking should be based upon the same. It is the good fortune that the reader has encountered such a book/course. Investment Banking: M&A Origination, Execution, Financial Modeling & Valuation explains origination, mandate/target matching, and deal structuring (i.e. how investment bankers actually make their money).

For those new to investment banking you are first going to want to clarify whether you would like to work on the sell side for a few years or pursue a career in investment banking. The skills that you will need to get started in investment banking are different than those that you will need to have a long and successful career in investment banking. The role in investment banking transforms from one that is research, financial modeling & valuation-based into one focused on origination and facilitating the M&A process. M&A (Mergers & Acquisitions) is the core product of investment banking, and the other products, advisory & capital-raising, simply support this. We founded Investment Banking University (www.InvestmentBankingU.com) to prepare students for both bulge bracket and middle market investment banking career opportunities.

We see a paradigm shift occurring in the field of investment banking. The idea that you need to spend three years of your life as an analyst doing 80+ hour workweeks building financial models to become an investment banker is a faulty paradigm. The real value add of an investment banker is not financial modeling & valuation, but rather origination, mandate/target matching, and deal structuring. You don’t need Goldman Sachs’ permission to be an investment banker just like you don’t need McKinsey’s permission to be a consultant. Investment banking for private companies in the middle market and lower middle market is a great way to build your initial coverage and career as an investment banker without sacrificing a family life or your health.

FOUNDATIONS OF VALUATION

In order to understand the role and work of the investment banker, we need to first have a strong understanding of the foundations of valuation. This helps us to understand why it is that the investment banking industry exists and where investment bankers fit into the bigger picture.

Part I: Introduction to Monetary Value

As a perpetuity is built, it becomes necessary to track the financial existence of the perpetuity through time. Accounting is the set of concepts, methodologies, and models that allows us to do exactly that.

Chapter 1: Introduction to the Capital Markets

Understanding how the global capital market is evolving is essential for CEOs and CFOs raising capital, financial institutions seeking to shape the market, policy makers tasked with regulating it, and investors seeking to profit from it.

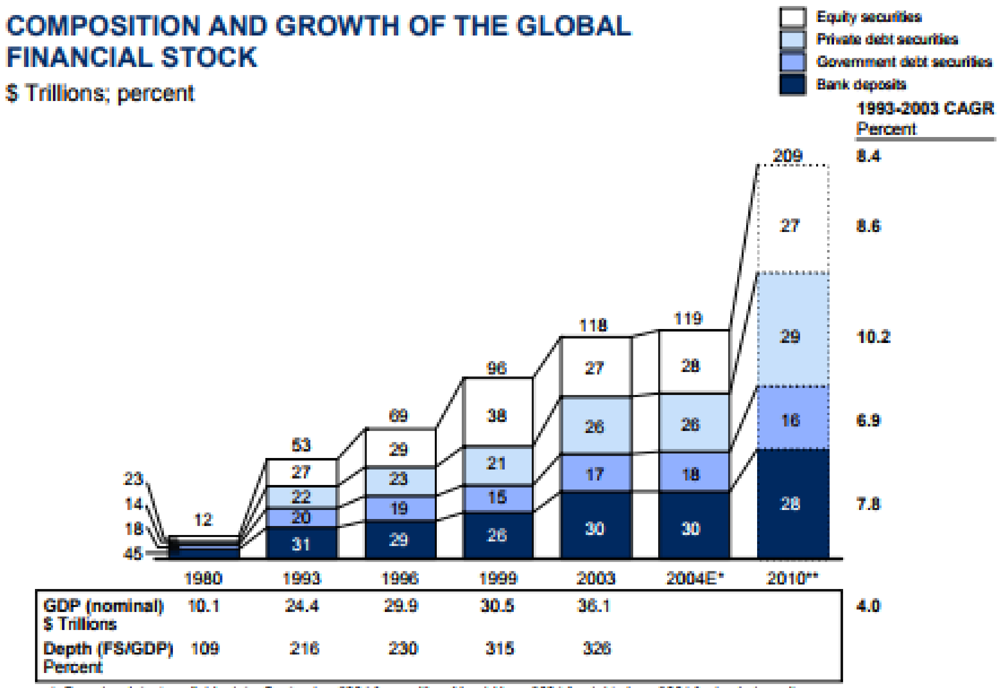
McKinsey created a database of the financial assets of more than 100 countries since 1980. Together, these assets comprise the global financial stock, or financial capital available for intermediation.

Among the three most important types of markets—those for capital, products, and labor—the global capital market is the farthest along the road to true global integration (marked by the operation of an international law of one price) and the one of the three that could best stake a claim to being an independent, motive force. The global capital market is thus a critical driver of growth and wealth creation.

The global financial stock the total amount of capital intermediated through the world's banks and capital markets and made available by them to households, businesses, and governments is now more than $118 trillion and will exceed $200 trillion by 2010 if current trends persist (McKinsey).

The lion's share of this growth in the global financial stock has come from a rapid expansion of debt

Exhibit 1



* Based on latest available data: September 2004 for equities, March/June 2004 for debt, June 2004 for bank deposits
** Extrapolation off of 2003 base, with components grown at 1993-2003 CAGRs
Note: 2004E shares do not add to 100% due to rounding error
Source: McKinsey Global Institute Global Financial Stock Database; World Federation of Stock Exchanges; Merrill Lynch; Global Insight

The roles that major countries and regions play in capital markets are changing. The United States plays the largest of them, attracting foreign issuers and investors alike. European markets are gaining in market share and depth, however, as they becoming more integrated. Meanwhile, Japan's role in global capital markets is diminishing while China has become a new force (McKinsey).

First, the development and expansion of financial institutions such as banks and stock markets far outpaces the growth in underlying GDP, resulting in financial deepening. While the global financial stock was similar in size to the world's GDP in 1980, today it is more than three times larger. Financial deepening is usually beneficial, giving households and businesses more choices for investing their savings and raising capital as well as promoting a more efficient allocation of capital and risk.

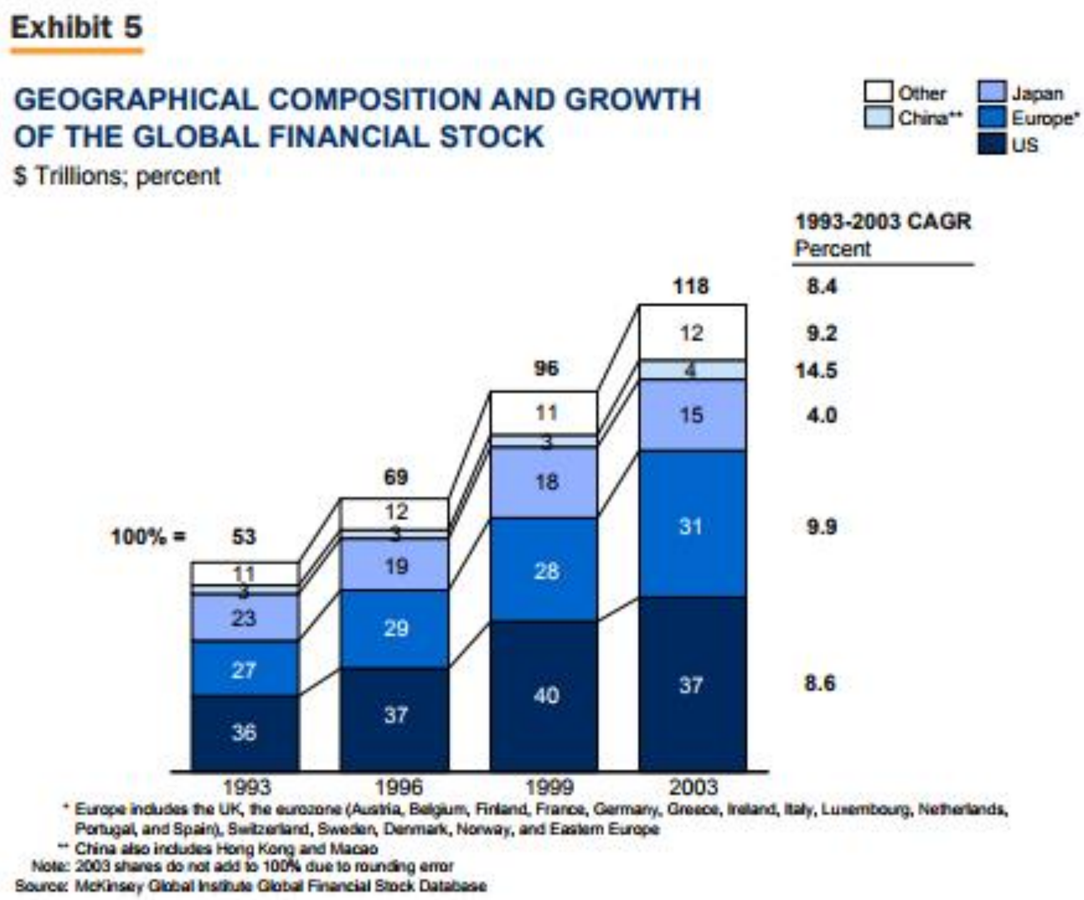
Second, debt securities are the most important asset class in the global financial stock. They hold the largest share of GFS and have been steadily expanding over time.

Financial deepening is usually beneficial, giving households and businesses more choices for investing their savings and raising capital, and enabling more efficient allocation of capital and risk.

financial deepening has been driven in the US by increased private sector intermediation

Equities have grown faster than the overall financial stock over the long run, but with considerable year-to-year volatility: in 1999, with equity markets soaring, equities were briefly the largest asset class in the global financial stock with a 38 percent share—by 2003 this share had fallen back to 27 percent. Over the past decade, growth in equities has occurred through a combination of new issues, earnings growth, and increases in the price-toearnings (P/E) ratio, with significant differences across countries. In the US, P/E increases since 1980 have been a meaningful source of equity stock growth, while in Europe growth has come mainly through increased earnings. Moreover, in the US, IPOs are a significant source of financial stock growth, while in Europe most newly floated shares come through privatizations.

Three markets account for more than 80 percent of the world's financial stock: the US, Japan, and Europe.



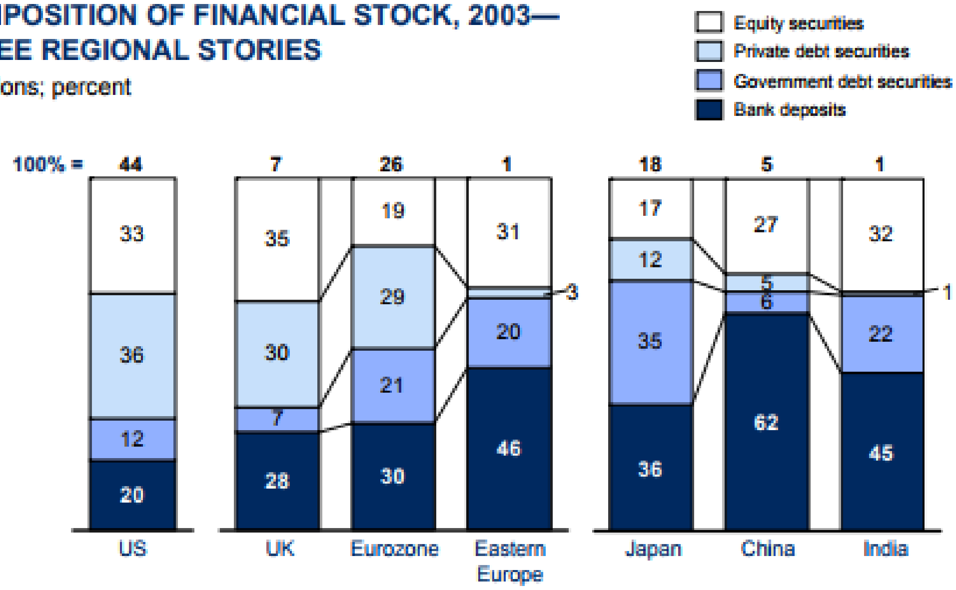
The US market is dominated by private debt and equity markets. In Europe, by contrast, banks play a larger role in finance, although European debt capital markets are growing quickly. Asian financial markets are relatively isolated from each other and display important differences. Japan has the region's largest financial stock, but is slow-growing. China's financial stock is among the fastest growing in the world but remains heavily reliant on bank intermediation—a concern given the fragility of China's banking system

Patterns of financial asset growth vary across geographies. In the US, initial public offerings of small companies are a significant source of equities growth, as are increases in P/E ratios. In Europe, by contrast, increases in earnings and newly floated shares from privatizations of state-owned firms explain most equity growth. In Japan, a huge expansion of government debt is the only meaningful source of financial stock growth, while the stock of equities and private debt securities has actually declined. In China, although bank deposits account for two-thirds of the financial stock, debt securities show the fastest growth (Exhibit 7).

Exhibit 6

COMPOSITION OF FINANCIAL STOCK, 2003— THREE REGIONAL STORIES

$ Trillions; percent



	US	UK	Eurozone	Eastern Europe	Japan	China	India
Depth (FS/GDP) Percent	397	385	314	99	411	323	137
CAGR Percent	8.6	11.3	9.8	19.3	4.0	14.5	11.9

Note: Some numbers do not add to 100% due to rounding error
Source: McKinsey Global Institute Global Financial Stock Database; Global Insight

THE US DOLLAR AND US MARKETS REMAIN AT THE HUB OF A RAPIDLY INTEGRATING GLOBAL CAPITAL MARKET

it is no longer accurate to think in terms of national financial markets. Instead, individual markets are becoming increasingly integrated into a single global market for funding, as cross-border holdings of financial assets and cross-border flows of capital grow.

This growth is clear evidence that despite the financial crises and anti-globalization backlash of recent years, the global capital market continues to integrate and develop.

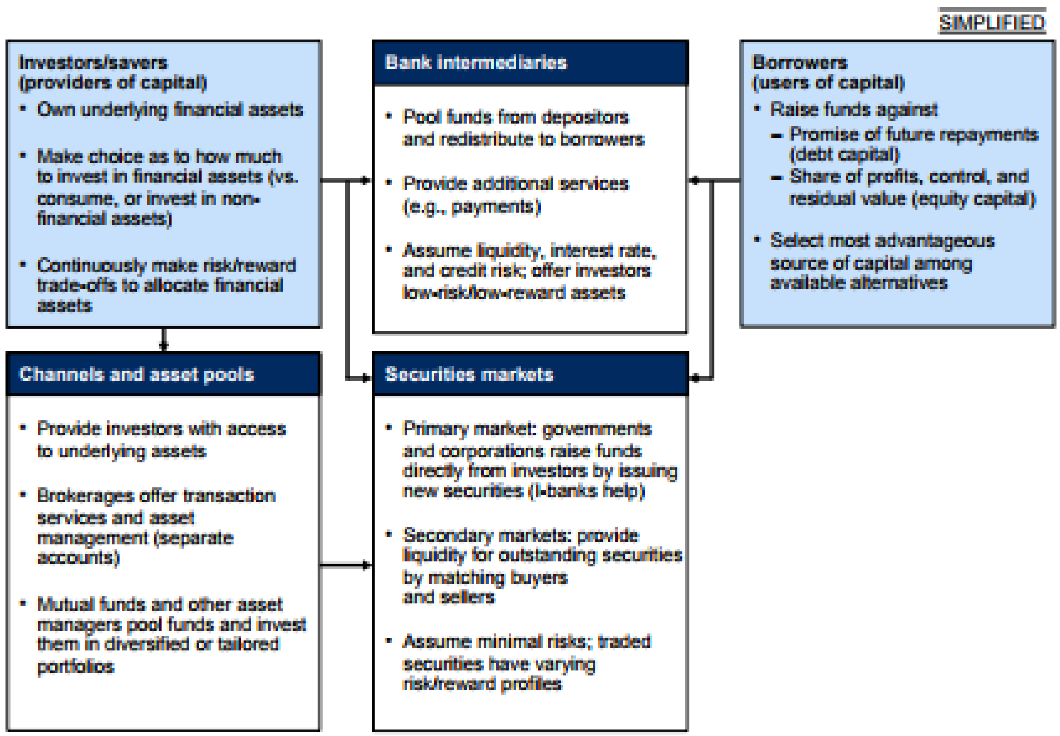
US markets remain at the core of this rapidly integrating and evolving global capital market. The lion's share of the world's cross-border capital flows are intermediated through US financial markets.

the dollar continues to dominate global finance. It is the world's most heavily traded currency and the preferred currency for issuing equities and bonds. Many other countries, including China and Malaysia, have tightly linked their domestic currencies to the US dollar. Although the euro is gaining notice among the world's central bankers, it is a long way from matching, let alone surpassing, the role of the dollar in international finance

we broadly define the global capital market as the cumulative collection of markets where global capital supply is matched with global capital demand through bank and securities market intermediation.

Exhibit 2

FIVE MAJOR PARTICIPANTS IN THE GLOBAL CAPITAL MARKET



We view the global capital market as the marketplace where five types of participants meet to match the available capital supply and demand:

1. Investors/savers: providers of capital who supply funds in exchange for financial assets that promise return and have an inherent level of risk, and who continuously make risk/reward trade-offs to allocate their financial assets.
2. Borrowers: users of capital who raise funds against a promise of future repayment (debt capital) or a share of profits, control, and residual value (equity capital). Borrowers select their preferred source of funds from among available alternatives.
3. Bank intermediaries: deposit-taking institutions that pool funds from

depositors and redistribute them among borrowers. Banks assume liquidity, interest rate, and credit risk and retain a spread between the cost at which they extend credit and the price that they pay for deposits.
4. Securities markets: broad set of financial institutions that collectively support the issuance and trading of securities. The primary markets allow governments and corporations to raise funds directly from investors by issuing new securities, while the secondary markets provide liquidity for outstanding securities by matching buyers and sellers. In contrast to banks, markets directly match investors with borrowers (that is, they disintermediate the market for capital) and assume minimal risks.
5. Channels and asset pools: we have chosen to view asset managers and other asset pools as "channels," because they manage portfolios of deposits and securities on behalf of investors, and serve as a pass-through vehicle of savings channeled toward borrowers. Mutual funds, pension funds, and insurance companies are included in this category.

To size the global capital market, we have profiled the global financial stock, as defined by the sum of the global bank deposits, the market value of publicly traded equities, and the outstanding face value of debt securities

3 Financial stock component

- **Equity securities = domestic stock market capitalization**
  - Based on data from Standard & Poor's (S&P) *Global Stock Markets Factbook*
  - Measured at end-of-year market values (shares outstanding* price) expressed in current US dollars
  - S&P manually tracks American Depositary Receipts (ADRs) with significant market capitalization to exchange where headquarters are located (i.e., Ford ADRs attributed to US equity market capitalization)
- **Debt securities = debt securities issued in the country**
  - Based on Bank for International Settlements' (BIS) *Quarterly Review*, September 2004, plus unpublished data on international debt breakdown by sector
  - Measured at face values of outstanding debt, in current US dollars
  - Broken down into private vs. government** and domestic vs. international debt
    - Private debt securities are issued by financial institutions and by corporations, including agencies (i.e., government-sponsored enterprise in the US). Government debt securities are issued by the central/local government and the central bank
    - Domestic debt securities are those issued by a resident issuer, in a local currency and, in BIS's judgment, targeted at local investors; otherwise debt securities are classified as international
- **Bank deposits = private demand, checkable, term and other notice deposits + money market mutual funds and accounts +(small amount of) money in circulation**
  - Based on data from International Monetary Fund's (IMF) *International Financial Statistics Yearbook*
  - Measure at end-of-year levels in current US dollars
  - Some methodological differences exist across countries
  - Maps to BIS's money supply = money + quasi-money + money market (broad definition of money)

Two important distinctions underlie the findings in this report: intermediation by markets versus banks, and government debt securities versus other asset classes.

Market intermediation versus bank intermediation (also tradable versus non-tradable instruments)

The stock of equity and debt securities represents the degree of market intermediation in an economy, since they are the instruments used by the financial market to directly match up those who want to invest money with those who want to raise capital. Because equity and debt securities may be traded on the markets, we often refer to them collectively as tradable instruments (although depending on their liquidity and turnover, some securities may not be actually traded).

In contrast, the stock of bank deposits represents the degree of bank intermediation in an economy, since bank deposits are the capital that the banking system channels from savers to borrowers (simplistically speaking, bank deposits fund bank lending).10 Since capital intermediated through the banks is less easily transferable than stocks or bonds, we refer to bank deposits as non-tradable. In general, governments have greater ability to regulate the banking sector than they do the financial markets. Thus, the degree of government control over the financial system bears an important relation to the extent of bank intermediation.

Government debt securities versus other asset classes

Equity securities, private debt securities, and bank deposits (which fund bank loans) are the main classes of instruments for intermediating capital between borrowers on one hand and investors and savers on the other. As these three elements of the financial stock increase, the economy becomes more efficient at allocating capital to its best use. Government debt securities are quite different. They function more as an instrument to redistribute taxes across generations than as a means to allocate capital from savers to borrowers. Although a well-developed market for government debt securities supports the development of a private debt securities market, government debt does not directly help firms to raise capital and grow. a large financial stock dominated by government debt securities is a sign of a high degree of future generation liabilities, rather than a sign of more efficient capital allocation.

pg. 45 McKinsey Global Financial Stock Report

The US maintains a unique role as the hub for GCM, which bolsters its dominance in private debt and equity securities. Europe is integrating quickly and is gaining global share across all asset classes.

Notably, the US financial stock is dominated by securities—private equity and debt—to a much greater extent than other markets in the world, with a relatively limited role played by US government debt securities.
The US accounts for the largest share of the global financial stock (37 percent). The total US financial stock is now $44 trillion, more than double its size 10 years ago, a growth rate of 8.6 percent a year since 1993, in line with the overall global rate of 8.4 percent.

The size of the US financial stock relative to GDP has increased from 179 percent in 1980 to 397 percent in 2003 due to growth in private debt and equity securities.

The eurozone is now the second most important region in the global financial stock, following the monetary integration of 12 European countries and the introduction of the euro. The UK acts as Europe's financial hub and is a global foreign exchange hub.

In contrast to the US, which is a single market, and Europe, which is in the process of integrating its capital markets, there is little cross-country capital market integration in Asia. Thus, the Asian capital market is largely a sum of the parts-a collection of distinct, national markets. The more developed of these markets have strong links with the global capital market, yet they seek only limited cooperation with one another.
Japan is a large though declining player in the global capital market while China is emerging as a force. Korea has a developed economy and India has an untold economic potential but neither of them come close to the size of China's financial stock.

Part I: Tracking Monetary Value (Accounting)

As a perpetuity is built, it becomes necessary to track the financial existence of the perpetuity through time. Accounting is the set of concepts, methodologies, and models that allows us to do exactly that.

Thank you for downloading the teaser version of Investment Banking System: Building a Middle Market M&A Practice. Please purchase the full book at Investment Banking University's website. Once you purchase, you will be given an automatic download link so there is nothing that needs to be shipped to you.

The book will allow you to enter investment banking on your own terms and build a middle market M&A practice today. The book and courses go through the Investment Banking Model as it relates to valuation, M&A origination, and execution. It is truly is the science of investment banking and it will get you deals & investment banking fees.

Best,
Michael Herlache MBA
Founder, Investment Banking University