

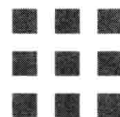


DAVID P. STOWELL

INVESTMENT BANKS, HEDGE FUNDS, and PRIVATE EQUITY

SECOND EDITION





Investment Banks, Hedge Funds, and Private Equity

Second Edition

David P. Stowell



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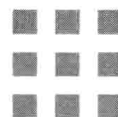
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Preface

The world of finance has dramatically changed following the global financial meltdown of 2007–2009 and ongoing financial challenges during 2010–2012. Market participants have been significantly impacted and attitudes toward risk, transparency, regulation, and compensation have changed. Investment banks, hedge funds, and private equity firms are at the epicenter of a transformed financial landscape, forging new roles and seeking new ways to create value within a paradigm of lower risk and greater regulation. This book provides an overview of investment banks, hedge funds, and private equity firms and describes the relationships between these organizations: how they both compete with and provide important services to each other and the significant impact they have on corporations, governments, institutional investors, and individuals. Together, they have reshaped global financing and investing patterns, attracting envy and awe but also criticism and concern. They dominate the headlines of the financial press and create wealth for many of their managers and investing clients. This book enables readers to better understand these heavily interconnected organizations and their impact on the global financial market by detailing their historical development and principal activities, the regulatory environment, and the risks and opportunities that exist in the postcrisis world.

Ultimately, the objective of this book is to demystify investment banks, hedge funds, and private equity firms, revealing their key functions, compensation systems, and unique role in wealth creation and risk management, as well as their epic battle for investor funds and corporate influence. After reading this book, the reader should better understand financial press headlines that herald massive corporate takeovers, corporate shareholder activism, and large capital market financings, and be able to discern the myriad strategies, risks, and conflicts in the financial market landscape. The inclusion of case studies and spreadsheet models provides an analytical framework that allows the reader to apply the book's lessons to real-world financing, investing, and advisory activities.

Target Audience

The target audience for this book includes MBA, MSF, and Executive MBA students, and upper-level undergraduates who are focused on finance and investments. Investment banking classes can use this book as a primary text, and corporate finance and investments classes can use it either as a secondary text or as a principal text when focused on hedge funds and private equity. In addition, professionals working at

investment banks, hedge funds, and private equity firms can use the book to broaden their understanding of their industry and competitors. Finally, professionals at law firms, accounting firms, and other firms that advise investment banks, hedge funds, and private equity firms should find this book useful as a resource to better understand and assist their clients.

Distinguishing Features

This book is unique for two reasons. First, it is a product of a long career working for and with investment banks, hedge funds, and private equity firms, in addition to seven years of teaching students about these institutions. Second, by addressing all three of these institutions in the same book, and focusing on their simultaneous competition and cooperation with each other, the book provides a more holistic view of the changing boundaries and real-world impact of these institutions than has previously been available.

I wrote this book following a twenty-year career as an investment banker at Goldman Sachs, J.P. Morgan, and UBS, and an additional four years at O'Connor & Associates, a large hedge fund that is now part of UBS. As an investment banker, in addition to completing numerous M&A, debt and equity financing, equity derivative, and convertible transactions with corporate clients, I worked with private equity firms (financial sponsors) as they acquired companies and pursued exit strategies through recapitalizations, M&A sales, and IPOs. Since 2005, I have been a professor of finance at Northwestern University's Kellogg School of Management, where I have had the privilege of teaching what I learned during my pre-academic career while completing ongoing research into the ever-changing landscape of investment banks, hedge funds, and private equity. Teaching these subjects in classrooms has provided greater objectivity and the opportunity to refine concepts and make them more relevant to students. This book is therefore a blend of practitioner experience and academic experience, creating a new educational offering that more fully opens the door to understanding the key participants in the global financial and advisory markets.

Case Studies

The inclusion of ten cases facilitates greater understanding of the concepts described in the chapters. These cases focus on recent actual financial and advisory transactions and include a summary of risks, rewards, political considerations, impact on corporations and investors, competition, regulatory hurdles, and other subjects that are linked to chapter topics. The cases include questions for students and case notes and teaching suggestions for instructors. In addition, several case studies include spreadsheet models that allow readers to create an analytical framework for considering choices, opportunities, and risks that are described in the cases. The cases are assembled together at the end of the book, but are all linked to preceding chapters. As a result, cases are designed to be used in conjunction with chapter reading to reinforce concepts and enhance learning.

The World Has Changed

During 2008, Bear Stearns collapsed into a fire sale to JPMorgan Chase; Lehman Brothers declared bankruptcy; Fannie Mae and Freddie Mac were placed into U.S. government conservatorship; the U.S. government assumed majority control over AIG and injected more than \$100 billion to keep it afloat; Countrywide and Merrill Lynch both sold themselves to Bank of America under duress; Wells Fargo bought Wachovia at the brink of bankruptcy; Washington Mutual went into receivership with its branches absorbed by JPMorgan Chase; Goldman Sachs and Morgan Stanley became bank holding companies; and banks all over the world had to be rescued by their respective governments. In the United States, this included the rapid provision to banks of over \$200 billion of equity capital by the U.S. Treasury as part of a larger \$700 billion rescue program, guarantees of debt and asset pools by the FDIC totaling many hundreds of billions of dollars, and an unprecedented expansion of the Federal Reserve's balance sheet by trillions of dollars as it provided credit based on almost any type of collateral. All of this occurred as the world experienced the most significant globalized downturn since the Great Depression in the 1930s. The global markets rebounded somewhat during 2010–2012, but financial anxiety continued as regulators sought to shore up financial institutions by requiring an increase in capital and a reduction in risk.

The investment banking business, in many ways, will never be the same. Leverage has been reduced, some structured financial products have ceased to exist, and regulation has increased. However, the fundamental business remains the same: advising corporations and investors, raising and investing capital, executing trades as an intermediary and principal, providing research, making markets, and providing ideas and capital directly to clients. As investment banks reinvent some aspects of their business and learn to live in a world of decreased leverage and increased regulation, new opportunities loom large while issues such as public perception, compensation, and risk management must be carefully worked through.

Hedge funds and private equity funds suffered significant reversals during 2008, with hedge funds recording investment losses of over 19% on average and private equity firms acknowledging similar potential losses to their investors. Although these results were undesirable and caused some investors to abandon funds, the global equity markets fared even worse, with the major U.S. stock market indices dropping by more than 38% and other equity and nongovernment debt indices throughout the world posting similar, or greater, losses. Hedge funds and private equity have had to adjust to a changing landscape and re-explain their value proposition while contending with downsizing in the number of funds, assets under management, and return expectations. Reinvention and patience were the watchwords during the global financial crisis as these funds fought to hold on to as many limited partners as they could while considering new investment strategies for a credit-deficient world. During 2009–2012, many hedge funds and private equity firms bounced back, with positive returns for most hedge funds and a refocus on smaller and less leveraged investments the hallmark of private equity investment activity.

Investment banks, hedge funds, and private equity firms have redefined their roles and developed new processes and business plans designed to maintain historical positions of power and influence. The world has changed, but these institutions will continue to have a significant impact on global capital markets and M&A transactions. This book projects how they will achieve this and the resultant impact on corporations, governments, institutional investors, and individuals.

Structure of the Book

The book is divided into three parts. The first part comprises ten chapters that focus on investment banks. The second part includes five chapters that discuss hedge funds and five chapters that review the activities of private equity firms. The third part of the book includes ten cases that focus on recent transactions and developments in the financial markets. These cases are cross-referenced in the preceding chapters and are used to illustrate concepts that benefit from more rigorous analysis.

Part One: Investment Banking

This part includes ten chapters that provide an overview of the industry and the three principal divisions of most large investment banks, including descriptions of the M&A and financing activities of the Banking Division; the intermediation and market making, as well as principal activities, of the Trading Division; and the investment gathering and money management activities of the Asset Management Division. In addition, the other businesses of large investment banks and the activities of boutique investment banks are reviewed. Other chapters focus in more detail on financings, including the activities of capital markets groups and the underwriting function, and discussion of IPOs, follow-on equity offerings, convertibles, and debt transactions. The role of credit rating agencies, prime brokerage groups, research, derivatives, and exchanges is also explored. Finally, regulations, leverage, risk management, clearing and settlement, international investment banking, career opportunities, and the interrelationship between investment banks, hedge funds, and private equity are discussed. The capstone chapters in this part of the book drill deeply into M&A, convertible securities, and investment bank innovation.

Part One is designed to be used as the text for a full course on investment banking. It should be used in conjunction with cases in Part Three that are specifically referenced in Part One chapters. Part Two's hedge fund and private equity chapters may be used as supplemental material.

Part Two: Hedge Funds and Private Equity

The first five chapters of Part Two focus on hedge funds, including an overview of the industry; a focus on selected hedge fund investment strategies; shareholder activism and the impact of hedge fund activists on corporations; risk, regulation, and organizational structure of hedge funds; and a review of performance, risks, threats,

and opportunities, as well as the changing value proposition offered by hedge funds to their limited investor partners. Finally, hedge fund competition with investment banks and private equity is reviewed, as well as the symbiotic relationship between all three parties.

The last five chapters of Part Two examine private equity from the perspective of those firms that principally focus on leveraged buyouts (LBOs) and other equity investments in mature companies. These chapters provide an overview of private equity; an explanation of an LBO model and how it drives decision making; the impact of private equity on corporations, including case histories of more than a dozen LBO transactions; a description of organizational structures, compensation, regulation, and limited partner relationships; and a discussion of private equity issues and opportunities, diversification efforts, IPOs, historical performance, and relationships with hedge funds and investment banks.

Part Two is designed to be used as the text for a full course that focuses on hedge funds and private equity. It should be used in conjunction with cases in Part Three that are specifically referenced in Part Two chapters. Part One's investment banking chapters may also be used as supplemental material.

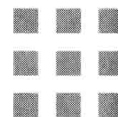
Part Three: Case Studies

This part contains ten cases that are referenced in different chapters in Parts One and Two. The cases enable students to drill deeper into the subject matter of the chapters and apply concepts in the framework of real transactions and market developments. Case questions (and teaching notes for instructors) are provided, as well as several spreadsheet models that enable students to manipulate data. The cases focus on the following: the dramatic change in the global investment banking landscape that occurred during the 2008 financial crisis; Freeport McMoRan's acquisition of Phelps Dodge, which focuses on M&A, risk taking, and financing activities; Proctor & Gamble's acquisition of Gillette, including the advisory role of investment bankers and discussion of corporate governance and regulatory issues; the divergent CDO investment strategies of two hedge funds, which in the first case resulted in excellent returns and in the second case caused bankruptcy; the acquisition through a bankruptcy court process and management of Kmart and Sears by ESL, one of the world's largest hedge funds; activist hedge fund investor Pershing Square's impact on the capital and organizational structure of McDonald's Corporation; the LBO of Toys "R" Us, focusing on the role of private equity funds and investment banks; and Cerberus's investments in Chrysler and GMAC (GM's captive finance subsidiary).

New Content in the Second Edition

The second edition reflects the most significant developments for investment banks, hedge funds, and private equity funds during 2009–2012 in relation to regulatory and tax considerations as part of ongoing global financial reform. In addition, developments

in the global competitive landscape are addressed and significant new content that focuses on international markets is included in many chapters. All time-sensitive exhibits have been updated, reflecting current information and considerations. Basically, this edition brings the reader up to date through 2012 on all of the key issues and considerations that impact investment banks, hedge funds, and private equity funds as key participants in the global financial markets.



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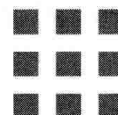
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