

# WHAT IS INVESTMENT BANKING?

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STARTING YOUR CAREER SEARCH

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# ABOUT SMITH HOWARD

Smith Howard was set-up by a former investment banker to educate candidates about their career options, in particular the range of options in investment banking. It also helps organisations with smaller graduate recruitment targets to access the highest calibre candidates.

If you would like more information about Smith Howard and how we can be of help to you in your career, please contact us:

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# 1. WHY DOES EVERYONE WANT TO WORK IN INVESTMENT BANKING?

Year in year out, there are high numbers of applications for the graduate programs at investment banks. A career in investment banking is one with great prospects which promises huge financial rewards.

Bankers work in a fast-paced, high pressured environment and are exposed to the highest profile deals that shape the financial markets. Whether you think you will be in finance for the long-term or you want to use investment banking as a stepping stone into another career, starting life as an analyst in an investment bank is a great first move. But what exactly does an investment banking organisation do?

## 2. INVESTMENT BANKING – BETWEEN CAPITAL AND COMPANIES

Imagine you are an entrepreneur about to set up a business, you will require 'money' to fund your business in order for it to grow and be successful. This is the case, not only for start-ups, but also for businesses already in existence. For some of the largest companies, the amount of 'money' (often referred to as capital) required can be in the millions and billions of pounds.

Because the sums of money can be so large and the way in which the money is raised is a complicated process, investment banks are hired to advise companies on financing alternatives and to help raise the capital that the companies need to grow. Investment banks can also help companies improve their business mix by advising on acquisitions and disposals of businesses.

In more formal speak, an investment bank is: **"A firm that serves as an intermediary between companies seeking to raise finance and investors, and which advises corporate and institutional clients on acquisitions, disposals, financial restructuring and risk management."**

Investment banks also operate in a number of other adjacent areas:

- **Asset management** – management of institutional wealth (insurance companies, pension funds, corporations)
- **Private wealth management** – management of private wealth (high net worth individuals)
- **Private equity** (often referred to as merchant banking) – medium to long-term finance provided in return for ownership or part-ownership of a company

# 3. FRONT, BACK AND MIDDLE

The operations of an investment bank are split into the front office, middle office and back office, which are constituted as follows:

## **FRONT OFFICE**

- = Corporate finance
- = Capital markets
- = Sales & Trading
- = Research
- = Structuring
- = Private equity
- = Asset management
- = Private wealth management

## **MIDDLE OFFICE**

- = Risk management
- = Finance
- = Compliance

## **BACK OFFICE**

- = Operations
- = IT / Technology

Most graduates applying for an investment banking graduate program will consider positions within the front office. However, this is one of the most competitive career choices open to graduates, often with hundreds of applications per place. The middle office and back office, whilst less competitive, do offer attractive careers, especially if you are interested in the other areas, e.g. IT, risk.

## 4. INVESTMENT BANKING VS RETAIL BANKING

A number of firms have remained 'pure' investment banks (e.g. Goldman Sachs, Morgan Stanley and Rothschild) whilst other investment banks also have retail banking arms (JPMorgan, Citigroup and Deutsche Bank). The investment bank, as described above, provides financing advice to companies whilst the retail bank can also lend the capital to the company following the investment bank's advice.

## 5. WHERE DOES THE CAPITAL THAT COMPANIES REQUIRE COME FROM?

Private individuals store or save their money in a number of different places, including in current and savings accounts in retail banks and in savings products (e.g. units in mutual funds and investments in hedge funds). They also save for their retirement and insure their possessions.

Therefore banks, asset managers, hedge funds, pension funds and insurance funds all act as aggregators of capital, referred to collectively as the 'buy side'. These organisations then invest in companies using investment banking organisations as their intermediaries.

It should be noted that private individuals can invest directly in companies, for example investing in shares of a company that is listed on the London Stock Exchange, this is referred to as the 'retail' market. This market is dwarfed by the 'wholesale' market, i.e. the 'buy side' organisations listed above.

# 6. DEBT VS EQUITY

Companies are funded in the main by two different forms of capital, debt and equity. Debt is money raised from banks and bondholders, and equity is money raised from shareholders.

In return for investing their capital in a company, shareholders are given a percentage of the company (a share). In return for the capital that banks invest, the company agrees to pay interest to the bank on the money borrowed and to repay the principal over an agreed time period. The capital that banks lend to companies is often secured on assets, similar to the way a mortgage is secured on a house.

The table below gives the main differences between debt and equity for a company.

	<b>Equity</b> <b>Higher risk / higher return</b>	<b>Debt</b> <b>Lower risk / lower return</b>
<b>Ownership</b>	Confers ownership to the holder	Does not confer ownership
<b>Right to benefit from capital appreciation</b>	Confers right to benefit from capital appreciation on sale or flotation	Capital value is fixed to the level of the original investment
<b>Participation in management</b>	Allows participation in management via the right to vote at company meetings	Does not allow participation in management
<b>Right to income</b>	Right to dividend payments but only if voted for by management and only if the company has sufficient reserves	Generally always receives guaranteed income of interest payments, irrespective of the company's profitability
<b>Repaid</b>	Generally never repaid	Always repaid
<b>Taxation</b>	Dividend paid after tax – i.e. they are not tax-deductible	Interest paid before tax – i.e. interest payments are tax deductible
<b>Security</b>	Unsecured	Generally secured by taking a charge on assets
<b>Ranking in insolvency</b>	Ranks last behind all other claims if the company becomes insolvent	Ranks high up the list of claims if the company becomes insolvent

## 6. DEBT VS EQUITY cont.

Shares (or stocks – the US term) are units of equity in a listed company. A listed company is one whose equity is recognised by a stock exchange, for example the London Stock Exchange (LSE). Listed companies have a value placed on their equity as its shares are regularly bought and sold via the exchange system. The total implied equity value of a company is calculated by multiplying the share price of the company by the number of shares outstanding. In a private company, the equity is still divided into shares that are held by the owners of the business, however there isn't a transparent value given to this type of equity as it is not bought and sold on a regular basis.

Debt is issued in two forms, loans and bonds. From the borrower's perspective both these securities are the same, the company receives cash and in exchange they pay interest on a regular basis. The only difference is who lends them the capital. Loans are normally issued by one bank (although they can be syndicated to a small number of banks), bonds are debt which is split into smaller units and sold publicly to different types of investors. Markets are made in bonds, similar to the stock markets, so that investors can easily trade their investment.

There are also a number of hybrid instruments which combine the features of debt and equity. These include convertibles – debt instruments that are convertible into equity.

# 7. CORPORATE FINANCE VS FINANCIAL MARKETS

Corporate finance and Financial markets are the two traditional divisions of an integrated investment bank:

- **Corporate finance** - provides advisory services to allow companies to raise capital and acquire and dispose of businesses
- **Financial markets** - ensure that the capital can be raised from the 'buy-side' and is traded freely and efficiently

Some of the larger investment banks also have private equity, asset management/private wealth and retail banking operations. Whilst there are a number of smaller companies who just specialise in one or a handful of the areas shown on the diagram on the next page.

## COMPANIES

### CORPORATE FINANCE

#### ADVISORY

Origination  
Relationship management  
Sector teams  
Country coverage  
M&A  
Project finance

#### CAPITAL MARKETS

Equity (ECM)  
IPOs, secondary issues  
Debt (DCM)  
Bond origination & issuance, leverage  
finance, structured finance and asset finance

#### CORPORATE BROKING

Advisory relating to how the company  
is viewed by the capital markets

### FINANCIAL MARKETS

#### EQUITY

#### DEBT

#### SALES

Relationship building with the 'buy side' to gain their business and promote specific trades

#### TRADING

Market-making in securities quoting a bid-offer spread

#### STRUCTURING

Designing tailored financial products to suit the bespoke needs of clients

#### RESEARCH

Research the financial prospects of companies to produce notes to support sales & trading functions

#### RETAIL BANKS

#### ASSET MANAGERS / PRIVATE WEALTH

Regulated funds  
Pensions funds, insurance  
companies, mutual funds

Unregulated funds  
Hedge funds

#### PRIVATE EQUITY

## PRIVATE INDIVIDUALS



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