# Our Analyst's Take: Should Investment Banks be Public?

### *Introduction*

Following the devastating bear market of 2022 where trillions of stock market capitalization seemingly disappeared into thin air, The Rothschild family, the majority stakeholder of Rothschild & co. [ROTH: EPA], has decided to bid for the rest of the shares of the company in the hopes of taking it private.

Among the top 15 Global M&A advisory firms, Rothschild advised on over 450 deals in 2022 and topped the likes of Goldman Sachs [GS: NYSE], J.P. Morgan [JPM: NYSE], and Morgan Stanley [MS: NYSE] in deal volume. However, despite Rothschild's increased revenues and large deal volume, Net Income fell by 21% from 2021 to 2022. Rothschild's stock price also fell in 2022, hitting a 52-week low of €29.15 compared to €41.60 in the first week of January. Trading at half the price-to-earnings of its US-listed peers, the company has decided that a big change is needed which has driven the firm to announce a €3.7bn deal to purchase the remaining 45.5% of minority shares.

Why is Rothschild going private when some of its competitors such as PJT Partners [PJT: NYSE] and Perella Weinberg Partners [PWP: NASDAQ] only recently did the opposite?

In this edition of *Our Analysts' Take*, we will, through the use of a case study, dive into the advantages and disadvantages that the most reputable Investment Banks are facing with their ownership structures.

### *History of Investment Bank IPOs*

In the aftermath of the stock market crash of 1929 and during the Great Depression, there was a crackdown on Investment Banks and their practices. Notable examples of regulation that was put in place included the Glass-Steagall Act, the Securities Acts of 1933, as well as the Securities Exchange Act of 1934. The increased scrutiny severely hindered risk-taking, and consequently the profitability of Investment Banks over the next three decades. The Glass-Steagall Act prevented banks from engaging in investment and commercial banking simultaneously, forcing banks to decide in which industry they wanted to engage. This led to many firms splitting up. An example is JPMorgan, which was converted into 3 separate entities spanning Investment Banking, Commercial Banking, and Merchant Banking. The Securities Act forced a registration of every offer and sale of securities, thereby adding an additional layer of complexity and administration to financial activities. Finally, the Securities Exchange Act (establishing the SEC), which fundamentally changed trading on the secondary market, forced these trades to be carried out in a particular physical place ie. an exchange.

This bout of regulation continued into the late 1950s with the Bank Holding Company Act of 1956 which made it even harder for commercial banks to engage in investment banking activities. Coupled with previously existing laws, a period of low competition and bank specialization was inevitable.

A large change finally came in 1970 when NYSE rules were revised. The most important for the case of this article was that joint stock corporations were now allowed to be members of the NYSE. It is also worth mentioning that there was another significant change in 1970 which was the elimination of a rule that stipulated that the principal source of income for a member corporation must be from transactions as a broker-dealer.

A joint stock corporation was the predecessor of the modern-day corporation where shareholders owned the company and could buy and sell shares, and thereby ownership, freely. Therefore, by definition no company that was a member of the NYSE was allowed to be traded publicly until 1970. Due to the economic environment of stagflation in the mid-to-late-1970s, not many firms decided to immediately bring their shares to the market. That being said, one of the most notable companies that did list itself shortly after, in 1971, was Merrill Lynch which coincidentally was the first company on the NYSE to do so.

Regardless of the general economic condition, the 1970s saw a rapidly changing financial and technological environment. In 1976, the first index fund was created, and, over the course of the decade, mutual funds grew in popularity as well. In addition, automation and technology drastically increased the speed at which trades could be processed, helping the NYSE reach the milestone of 100 million trades in a day in 1982.

Many Investment Banks now considered listing their shares because flotation offered access to capital which could be used to invest in expensive technology to keep up with the high trading volume. However, some investment banks such as Goldman Sachs believed that it was best to maintain a partnership structure and preserve the status of their "elite" partners. Therefore, it comes to no surprise that it was one of the last bulge-bracket investment banks to list on the stock market, only going public in 1999 (Goldman Sachs).

Meanwhile, following the trend of financial innovation, small advisory firms and arguably predecessors for "boutique" investment banks began to appear. Typically, they were founded as a result of veteran bankers fleeing more established investment banks and starting smaller, more specialized operations. However, notable examples of these such as Hambrecht & Quist, Montgomery Securities, and Robertson, Stephens & Co. were acquired by the mid-1990s. This trend changed with the formation of Evercore [EVR: NYSE] and Greenhill [GHL: NYSE], established in 1995 and 1996 respectively, which have both since undergone an initial public offering. These two companies were pioneers in the investment banking business and now make up a substantial portion of global M&A Advisory fees.

In the last fifteen to twenty years, boutiques have continued to float their stock, but following Rothschild's buyback plan, we want to analyse why this trend exists and whether it makes sense for it to continue. Surely Goldman Sachs and J.P. Morgan had their reasons for holding off on their IPOs for the 28 years following Merrill Lynch.

### *What does it mean for an Investment Bank to be publicly traded?*

Over the last fifty years, investment banking partnerships have used IPOs as a solution to their problem regarding liquidity for partners. Private partnerships suffer from the illiquidity of their shares – partners who are given equity in the firm cannot sell these stocks on the open market and this illiquidity of shares often makes it hard for partners to leave the firm due to non-competes and clawbacks. Going public eliminates these issues and offers the partners the opportunity of a generous pay-out, especially considering the eyewatering valuations some of them floated at. When Goldman Sachs went public in 1999, they had 221 senior partners who collectively owned 264m shares. At the offering price of $53 a share, this equates to each partner owning on average $63m worth of Goldman Sachs' shares. We have seen this more recently, with many of the up-and-coming boutique investment banking partnerships going public, such as Perella Weinberg Partners hitting the markets via a $975m SPAC in 2021, only 15 years after it was founded.

Typically, firms go public to raise money to fund their expansion – investment banks are no different. The 1960s saw significant advances in computer technology which were essential to automating many back-office processes such as record-keeping and transaction processing. As such, many retail-oriented firms raised money through an IPO at a time when they were in greater need of physical capital rather than the human capital that had fuelled their previous growth. Consequently, the first wave of investment banking partnerships going public, which included firms such as Merrill Lynch, occurred in the 70s. The second wave of wholesale firms going public followed the introduction of the microcomputer in the 1980s. This new technology was essential for the adoption of new financial engineering techniques which served to lower the cost of entry into lucrative trading markets whilst also reduce the need for human capital. As a result, bid-ask spreads diminished and wholesale banks' returns on trading increased. Ultimately, wholesale and retail banks needed an injection of cash to invest in the constantly evolving technology to remain competitive in the industry.

Setting aside the need for technology, access to capital and a sizeable balance sheet through an IPO can be rather strategically advantageous to investment banks. Fundamentally, it enables the bank to lend money to clients to complement their other services from M&A advisory to trading. Banks often operate a leveraged finance division allowing them to provide financing to 'non-investment grade' companies and consequently diversify their revenue streams. Although this gives many of these 'bulge bracket' firms a competitive advantage, their market share in recent times has been eroded by a combination of boutique banks advising the deals and private credit funds financing them. This has been accelerated by regulations preventing banks from holding non-investment grade debt and the losses banks have made in the time between issuing loans and syndicating the debt.

Despite the advantages of being public, it does not come without the drawbacks that many firms suffer from. One of the bigger issues they face is the shareholder scrutiny over bankers' compensation. The short-sightedness of some shareholders can lead to pressure on the banks to reduce the percentage of revenues paid out as salaries and bonuses to maximise profits and dividend pay-outs whilst maintaining a healthy share price. As a consequence of constrained compensation, we have seen many premier dealmakers leave to either start up their own shop or join a private independent investment bank focusing on financial advisory. Perhaps one of the most famous examples is Ken Moelis leaving his position of president of UBS Investment Bank to co-found Moelis and Company [MC: NYSE] in 2007. Since inception they have advised on more than $4tn of transactions and went public in 2014 in an IPO valuing the firm at $1.6bn. This brain drain of talent has led to the bulge bracket investment banks losing out on senior talent and subsequently a decline in growth and market share.

### *The double-edged sword of partnership structure*

Private investment banks have risen in quality and prestige in recent years, with Centerview Partners leading the way. The tight-knit environment & smaller size that being a private bank with a partnership structure enables you to have not only leads to exemplary performance as we have seen at Centerview but also allows for a more entrepreneurial culture in developing young talent through mentoring. Large deals that Centerview has recently worked on include advisory to the Newmont Goldcorp Corporation for an acquisition of Newcrest Mining Limited valued at $17bn and services to Oak Street Health on its sale to CVS Health for a value of $10.6bn. Leaner deal teams in boutiques have shown incredible success as the total market share of M&A activity has increased annually since 2005. The advantages in terms of culture lead to the ability to work more exclusively on top-of-the-line deals and produce higher-quality service. Due to the small nature of the private boutiques, there is better oversight on individual deals. Higher patience on behalf of senior personnel and a more nuanced evaluation of performance leads to a more efficient company. Thanks to this, banks are able to pay their bankers more leading to higher retention rates and enables the firm to hire the top bankers from competitors. Private boutiques may also be able to dodge bonus caps and retain talent by offering more competitive compensation. On average elite boutiques pay 20-30% more than large, diversified Investment Banks. Due to their longer analyst classes that last 3 years and several bonus clawbacks and large compensation for their analyst to associate promotes elite boutiques are able to retain talent through compensation. This leads to less conflict when sharing in profit as there is a lack of shareholders criticising pay across the board. Leaner operations also benefit from less leaks as there are less people to account for.

 

One of the main benefits of undergoing a partnership structure is that it theoretically should foster more talent than an investment bank. A reputable investment bank will have a very large pool of talent to choose from, but the degree of mentorship is far more pronounced in a partnership structure. The theory, as proposed by Alan D. Morrison and William J. Wilhelm, Jr (2008, The Journal of Finance) states that partnerships create a strong "up or out" employment policy. The up-or-out policy that forces milestone achievement on members in exchange for employment at the company seems to have become more mainstream throughout investment banks. Although it might seem unconventional, it can provide a large difference in the talent that firms foster. The logic behind the theory is that in a partnership ownership structure, each partner wears the brand of the firm and therefore their performance is directly related to company performance and most importantly their bonus pay-out. This means that a partner cannot afford to have a team with underperforming members. If a partner discovers, perhaps through his mentoring, that one of the junior employees lacks the talent that characterises the firm, it is in the partner's and the firm's best interest to get rid of the employee. One thing that makes this easier to do in a partnership (a privately owned enterprise) is the opacity regarding operations and actions that come from within. Historically, this is one of the main reasons why Goldman Sachs and J.P. Morgan waited before proceeding with an IPO. They felt that they could continue to perform at a high level by relying simply on the expertise of their employees.

Additionally, one of the benefits of being a private M&A boutique is the lack of a conflict of interest between other business units. Large bulge brackets need concrete Chinese walls between their investment banking and sales & trading divisions to avoid regulatory scrutiny. Private M&A boutiques that specialize on one business unit do not have such conflicts. This also leads to a less volatile environment for private partnerships when compared to publicly listed giants like Goldman Sachs and J.P. Morgan. Several large financial institutions that have gone public have had to account for prioritising shareholder interest and maintaining their personnel or investors content. The Blackstone [BX: NYSE] IPO in 2007 was conducted after a large amount of due diligence on behalf of CEO Stephen Schwarzman who was concerned about having to choose between his companies shareholders' interests and the intention of his investors which were not always aligned. Similar problems arise with public investment banking boutiques that have private equity and merchant banking divisions.

M&A activity is volatile and the ability to generate profit through investment banking is never guaranteed. The Covid-19 pandemic halted several years of increasing deal flow, enabling investment banking boutiques to churn out a record number of deals. Investment banks that used capital raised via an IPO to expand their divisions and grow substantially have lost some of their flexibility and have had to rely heavily on diversification to perform in economic downturns. Private partnerships that have expert partners capitalized on this opportunity to utilize their flexibility and adapted to the economic downturn. The more diversified boutiques like Houlihan Lokey [HLI: NYSE] and PJT Partners were able to capitalize in the downturn and have strongly relied on their established restructuring businesses to rake in money respectively. Their shares rose sharply in 2020 compared to their M&A-focused counterparts such as Evercore, Greenhill and Lazard [LAZ: NYSE]. The response on behalf of investment banks lacking deal flow is a shift to restructuring but one wonders whether it's sustainable.

During times of economic uncertainty M&A activity drops across the globe and in such so does the possibility of banks to earn profits. The inverse relationship between M&A activity and companies' need for restructuring is a haven for firms that can specialize in both. To weather the storm of a looming recession underperforming firms are forced to restructure internally to maximize their cash flow. Minimizing their costs and improving efficiency for a company during hard times may lead to a more opportunistic set up to maximize future profits. One possible advantage is the fact that restructuring clients during an economic downturn could become M&A clients during a boom in the economy. The 2008 financial crisis forced financially solid companies to restructure and this led to the development of acquisition targets for firms that were not in a vulnerable position. This is a trend that we could see develop in this current market cycle. There is simply less space available at the publicly listed bulge bracket shops to retool M&A advising teams as restructuring experts. Restructuring can lead to conflicts of interest with current or potential loan connections, leading most major banks to steer clear of it. However, with the current macroeconomic situations even M&A bankers at large institutions are weighing their options. Being specialized in restructuring also enjoys the fact that the learning curve is extremely steep which prevents firms from quickly adapting to conduct restructuring as a practice. The inability to learn to restructure effectively in a short time enables specialized boutiques to have less competition in the restructuring market. Finding the right balance between the offering of restructuring & M&A advisory is the catalyst for the success of private investment banking boutiques looking forward.

Partnerships also have an extremely strong reliance on their partners which could be their Achilles heel in the future. Several transactions benefit from having a bank that can both advise on the M&A transaction and finance it, rather than just having the advising component and having to look elsewhere for the financing. This example also persists on the trading side where it is beneficial to trade with a bank that can provide you with cheap leverage rather than just having a bank that helps you trade. This allows us to arrive to the conclusion that having capital is a large advantage for public banks when compared to partnerships. The ability to lend money allows public institutions with large balance sheets to make large amounts of money.

The crux of any investment banking deal is privacy. Whether it be a merger or an acquisition the secrecy preceding the announcement of a deal or bid is of key importance regarding the execution of the proposal. Large investment banks have a notable imperfection in this regard which is their sheer size. The "Partners" at bulge brackets do not necessarily have as much money to risk when compared to their counterparts in elite boutique partnerships coupled with the large teams and departments that might be working on one particular deal this could cause leaks that ultimately ruin a transaction. A great example of this is when a client is planning a hostile takeover & the bid is indirectly leaked from a large financial institution. First Abu Dhabi Bank (FAB) planned a takeover of Standard Chartered, which got leaked and ruined the proposed bid. Consequences also followed as the FAB was not allowed to pursue further action for a six-month period unless another bidder presented themselves. The FAB had hired Moelis & Company to advise them in possible transactions following their involvements in the Lebanese banking market and their bid for the Egyptian company EFG-Hermes. Although Moelis & Company is a boutique, it is publicly listed and has grown in recent years to surpass a thousand employees – for reference Centerview Partners has circa 400 employees. Elite private partnerships provide opacity and give clients the needed element of surprise when putting forward bids for hostile takeovers.

### *A case study: Rothschild & co.*

Last month the Alexandre de Rothschild announced his family's intention to take their investment bank, Rothschild & Co, private in a deal valuing the bank at €3.7bn. Their family holding company, Concordia, already owns 38.9% of the shares which represent 47.5% of the voting rights, whilst the wider Rothschild family owns over half the shares and two-thirds of the voting rights. Concordia is planning to offer €48 per share representing a 19% premium on the closing price the day before the bid was made. This move came somewhat as a surprise to many as it defies the industry trend of investment banks going onto stock exchanges, not coming off them.

The timing of the bid comes at a time when public equity valuations have been battered by interest rate hikes, economic uncertainty and concerns of a recession. This gives the Rothschild family an ideal window when their stock price is lower and their wealth management and merchant banking divisions are not quite as mature as they will be in a few years time. Ultimately the Rothschilds seem to be trying to capitalise on a cheap opportunity to buyout the firm and secure future dividend payments. By taking ownership, they are ensuring that future profits stay within the family instead of being paid out to public shareholders.

Another consequence of having public shareholders is the incessant pressure to hit earning targets each quarter, without necessarily having a long-term view on growth. This was a big part of the rationale behind the Rothschild family looking to take the investment bank private. They believed that the firm can focus on long-term growth without the burden of having public shareholders, especially considering that the growth in their units do not require public stock market access for capital: "It was clear that we had reached the limit and full potential of the listing". Evidently, there exists a tipping point where the benefits of having access to outside capital are outweighed by the limitations of having public shareholders for investment banks. Perhaps other elite boutique banks will monitor Rothschild and Co.'s performance over the coming few years before considering a similar move themselves.

### *Our Outlook for the Investment Banking Industry*

Having discussed the state of the investment banking industry above, we will now try to describe some emerging trends that we expect to persist over the next years. One development that we expect to continue is the demise of the European Universal Bank. Over the past years, UBS [UBSG: SWX], Deutsche Bank [DBK: XETRA], and Credit Suisse [CSGN: SWX] abandoned their ambitions of competing for the top spots in investment banking league tables. After a variety of scandals and continued underperformance, executives at these firms cut down the size of their investment banks, trying to focus on businesses that were more profitable and, importantly, more stable. We suspect that the next firm to go down this path will be Barclays [BARC: LON]. Despite managing to fend off an activist campaign by Edward Bramson, who petitioned for the firm to cut down its investment bank, the firm is unlikely to further resist the fate that has faced its peers, as its share price is continuing to underperform. With the investment banking business currently struggling, the firm will be particularly vulnerable to investors pushing the firm to cut it down.

The question naturally arises of why this fate is unique to European universal banks and not US ones. J.P. Morgan, Bank of America [BAC: NYSE] and Citi [C: NYSE] have continued to thrive with a diversified model, whilst their European counterparties have suffered. One argument could be that the Americans simply have a greater tradition in the business and are therefore better at it. However, we suspect that there are two main factors making investment banking structurally more profitable in the US, allowing US firms to maintain a universal offering, whilst their European counterparts cannot. The first of these factors is that US companies have traditionally relied on capital markets, meaning offering stocks and bonds, to finance themselves, whilst European firms are more reliant on direct bank loans. This means that there is simply a larger amount of business for investment banks in the US, providing them with some economies of scale. The second factor is clearly that investment banking fees are far higher in the US than across the pond. Thus, with higher fees and more volume, the US is the market where the lion's share of investment banking profits are made. As American banks are the leaders in their home markets, they naturally benefit from this. Due to their large profitability in the US, American banks can finance their European businesses and thus make it very hard for the European banks with smaller US businesses to compete in Europe. Thus, we expect universal banks to continue to exist in the US, whilst European banks will become more focused, with many radically reducing the size of their investment banks.

Another development that we expect to continue is the vertical integration of boutique investment banks. When they emerged, boutiques only advised executives on the tactics and related issues in a transaction, leaving a large pie of the fees to be earned from underwriting the financing, hedging foreign exchange risk, and more to the larger banks. In recent years, we have observed boutiques, most notably Evercore, expanding into many of these businesses (aside of course from the underwriting for which they don't have the balance sheets). Naturally, the potential pitfall with this expansion is that the boutiques may become so large that they lose some of their competitive advantages, which include being small and therefore less likely to leak information about a live deal.

 

We suspect that some firms will expand too much into other business lines and as a result start losing business. Other firms will then recognize how far they can expand without losing their edge, leading to a sort of steady state.

In addition, we anticipate that 'third way' banks will continue to prosper. We use the term 'third way' to refer to all those banks that are too large to be called boutiques, have small balance sheets, and co-operate with a large commercial bank to provide the deals that they are underwriting with financing. The most notable example of this is Jefferies [JEF: NYSE], which has registered large market share gains in recent years through employing the strategy detailed above. This has already spurred imitators such as Credit Suisse, which is spinning off its investment bank and will only provide the financing for the leveraged loans in the future, leaving the rest of the investment banking activities in the spun-off firm, which will be called CS First Boston. If Barclays were to indeed cut down its investment bank, we could imagine that it would follow Credit Suisse's example.

Finally, we anticipate that investment banks will continue to lose market share to private credit firms in the space of levered lending, due to the structural advantages private credit enjoys. The first is that when borrowing through private credit funds, borrowers can choose who their debtholders are going to be, in contrast to when a bank underwrites a bond issue and then syndicates the securities to the highest bidder. Another is that investment banks have been severely burned when underwriting leveraged loans over the past two years. They had underwritten risky covenant-light loans at low interest rates in 2020 and 2021. In the time between the banks making the loan commitment and the transaction being executed, the market environment shifted to one of rising rates. Naturally, this led to huge losses for the banks, which now had to sell the securities at large discounts. One can imagine that this will make banks more restrained when underwriting new debt, allowing private credit funds to further gain market share. A headwind to this development is that such funds are generally more expensive to borrow from than banks. However, it appears to us that being able to choose your debtholder and working with lenders that also finance you in more difficult market environments is something that firms will pay some basis points more in interest for.

TAGS: Investment Banking, Advisory, IPO, LBO, MBO, Boutique Investment Banks