



# THE BUSINESS OF MIDDLE MARKET INVESTMENT BANKING

## FOR CONSULTANTS OR OTHERS WHO MIGHT LIKE TO DO THIS KIND OF WORK

Mamas, don't let your babies grow up to be cowboys . . .

Willie Nelson

### Savannah, GA—October 1989

Peter was telling me one of the saddest professional stories I had heard in a long time.

At the quarterly meeting of our bank in Savannah, the one I had just recently begun to work with, Peter was telling me about Frank, who had been with the firm for three years and had just left. It seemed Frank spent the entire three years without a payday, and his wife and pocketbook had finally had it. Frank ran the firm's small office, which served Georgia and north and central Florida.

Peter told me that Frank had started out three years ago with incredible energy and enthusiasm. He had all the right background too: a graduate business degree, years of senior experience in financial services, and a personality capable of charming the leaves off trees. Peter said that by Frank's second year, he had churned up three very nice sales-side clients, and by his third year, two more. This is pretty good, actually, for a guy starting out fresh in the business. If even two-thirds of these deals closed, Frank stood to have a decent payday for all of his work. Somewhere well north of a million dollars would have been his cut.

The sad story was that none of them closed. The failures had nothing to do with Frank, either. Their causes were downright weird.

In one case, the sudden death of a client days before the closing raised estate problems that would not be resolved for years, and the business was taken off the market. In another case, a criminal action against a company he was representing, although later dismissed, eliminated any real possibility of a sales transaction at that time. In yet another case, the loss of a major distribution agreement by a sales-side client not long before closing was scheduled. You get the picture.

As I thought about this on the plane back to Washington I reflected on why contingent-fee investment bankers got the big bucks. It was a question, obviously, of the chances of getting them at all. I made up my mind then and there that I would tell Frank's story to every prospective banker that came to me for advice. While it might be a little extreme, it really did happen. I have stuck to my word.

## What is Investment Banking?

Not everyone has had the experience of working for one of the larger Wall Street investment banks; therefore, I have found that students often are not even totally sure what the term “investment banking” covers. I know that most of the public has only a vague and mostly erroneous idea that it has to do with something like investment advice regarding stocks and bonds (wealth management). I always recommend that to start in this profession, after appropriate training, one must first self-declare that he is an investment banker, and then declare to the community that he or she is one. Of course, if one is to make that declaration, it is good to know what the term means. I also want to help overcome any reluctance to that imperative (declaration of one's profession) by briefly explaining what investment banking most commonly means in usage<sup>1</sup>. A good place to start is by some contrasts:

Investment banking is not commercial banking (these are the guys we make savings and checking accounts deposits with and borrow money from, with deposit insurance provided by agencies of the U.S. government). Although both

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<sup>1</sup> This book is being final edited in September 2008 in the midst of the so called “deepest US financial crises since the great depression”. Over the last several weeks the distinctions between commercial banking and investment banking are undergoing enormous change at least in terms of how the industries are typically known to the public. . . With large commercial banks acquiring large investment banks and vice versa there is a rapid blending of the two historically different industries. However as a matter of functional operations the two different professions will continue to operate separately even where under common ownership.

groups are termed “bankers,” they are not the same thing at all. Investment banks consult with corporations on M&A and capital formation and in at least a part of their operations manage other peoples wealth and sell stocks and bonds and so forth. To some degree, the distinctions have been more obscure since 1999, when commercial banks were allowed to branch out into other financial services businesses (which had been prohibited for 66 years by the Glass-Steagall Act), but even now, strong firewalls have to be maintained between these two functions. For the most part, those commercial banks (almost always larger ones) that did branch out went into either wealth management (stock and bond advice) or investment banking as I am using the term here. For all intents and purposes, the investment banking business might as well be a separate company, in so far as operationally there seems to be little contact or synergy between that business and the traditional commercial banking business.

Investment banking is not merchant banking, either. Merchant banks (usually known in the United States as Private Equity Groups, or PEGs) invest their own money in acquiring companies. Investment banks do not invest their own money that way, as a rule and it is certainly not their main business although they may have organized a separate PEG to do so.

But, while large investment banks certainly provide wealth management services and stock-trading desks, these are also not usually what is meant by investment banking per se, especially as it is commonly used and as it is used in this book.

In short, investment banks either assist business (and sometime governments) to raise money and/or provide financial advice on transactions such as mergers and acquisitions. In the former case, they assist in raising capital by public offerings of stock or bonds and private placements of offerings with PEGs. A good way to think about investment banking, whether acting as agents and advisors in mergers and acquisitions (M&A) deals or in raising capital, is that this is a go-between function.. The money involved is almost always someone else’s and not that of an investment banking operation.

So get comfortable with the term. All you need is a broker dealer and securities licenses (discussed later in this chapter) and hopefully some experienced guidance (this is really important), and you are an investment banker specializing in M&A. If you come from another background, accounting or general financial consulting or valuation for example the term may initially seem unfamiliar and uncomfortable but this is what you are doing when you are advising clients on M&A and capital formation for a success fee.

# Some Ironies of the M&A Profession

I hope my love for transaction work has somehow seeped into this book. I cannot imagine a better professional life, and there are few professions that are as well-rewarded, for those who can stand the stresses and the financial ups and downs. The deep satisfaction that comes from applying long experience and various skills to making “deals” is exquisite—at least until you have to think about where to find the next deal—but that is the nature of the beast. When we do really good work for our sales-side clients, we lose them.

While I know that many seasoned Middle Market bankers pride themselves on their earlier operations background and experience, I think most of them would admit, at least in their hearts, that they are better deal people than operations people. You see, I believe you have to love what you do in order to perform at the top level of your profession.

## Attention Deficit Disorder and the M&A Banker

### **Exhibit 30.1 Small Consulting or CPA Practice versus Sales-Side Investment Bank: Impressionistic Illustration of Cultural Issues**

I think that operations and deal professionals are different, just as managers and strategists are different within operations. Deal professionals have, I think, shorter attention spans. We often kid about deal people having some peculiar form of career adult attention deficit disorder, and maybe some of us actually do, but put in a more positive light I think that those attracted to the deal profession have wide and eclectic interests. We simply love learning. A former associate of mine used to say that we are a mile wide and an inch deep. There is a lot to be said for that, although if that is the shape of our pond it is a highly unique pond in its own right. You need more than a wandering curiosity to succeed as a deal person; you also have to have the ability and tenacity to learn fast, very fast sometimes.

## People Skills

People skills are critical. I personally think that it would be a heck of a lot easier, at least in certain senses, to be a litigator as opposed to a deal attorney. A litigator can go for the throat of the opposition. Not that skill is not required, but

the deal attorney's approach requires a great deal more finesse. It involves not going for the throat, maybe going just close enough to get the best possible deal for his client, but most of all *getting the deal done*. This requires people skills and a great deal of self-knowledge and self-management.

Maybe this is why young people do not usually succeed as full-fledged bankers in Middle Market banking and must wait, in most cases, until probably their late thirties or even late forties to begin to achieve success in the field. Of course, in defense of young would-be-bankers, there is also the issue that clients who are about to undertake a \$50 million transaction simply usually feel better in the hands of perceived technical experience and maybe a little life experience as well.

If I were asked for the most important *nontechnical* attributes in someone considering entering this profession, I would say unequivocally that they are:

- Sufficient personal liquidity to survive the first two years
- If entry is first at the banker level, at least 35 years of age
- A real liking for people
- A real empathy for other people's views
- A love of diversity and change
- At least some financial background
- An analytic approach to problem solving

## Entry Points to Investment Banking in General

So how does one get into this profession? It is not necessarily easy, but the classic routes each have advantages and disadvantages. If the Middle Market is divided into thirds in terms of transaction value, then the lower third would be transaction values<sup>2</sup> up to \$150 million, the second third from \$150 million to \$500 million, and the upper third from \$500 million up to \$1 billion. I believe this framework is reasonably accurate and useful. I think they will give the reader a good idea of who does what in the Middle Market and serve as a good segue to the

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<sup>2</sup> As I continually point out in this book, the important relationship contained in the rough rule of thumb is that transaction size can be estimated as around 50% of the revenues of the sold company. I continue to point this out, in appreciation of the fact that many readers will be reading only those parts of the book that interest them—and rightfully so.

entry points into M&A investment banking. There are many variations of entry points into investment banking, but two with some subsets are classic. They are the small firm/big firm choice, which can also be expressed as the young person/older person choice and just as accurately as the financially secure person/non-financially secure person choice. Let me explain.

## **Boutique Banks, the Lower Third of the Middle Market**

The lower third of Middle Market transactions are primarily executed by small but real boutique investment banks, typically with four to five bankers, with some competition from the regional banks (maybe 20 to 50 bankers) . The boutiques are more likely to experience this competition when M&A activity is down and the regional firms reach down lower than their normally preferred deal sizes.

The upper third of Middle Market transactions are usually competed for by the large Wall Street investment banks and the larger regional banks. The same phenomena is true here in the upper third as in the lower third, as the Wall Street firms will tend to compete for smaller deals as the M&A market wanes.

The middle third is probably about equally done by all three groups of banks: the boutiques, the regionals, and the Wall Street banks. But most Middle Market deals are done by boutique investment banks, as most Middle Market deals are in the lower third of the market where these banks thrive and where most of Middle Market deals take place.

## **Direct Entry as a Banker through a Boutique Firm**

Boutique investment banks, especially those in the lower third of the Middle Market , often operate on a financial structure that is known, not too pleasantly, as *Eat What You Kill* (EWYK). This financial structure handsomely rewards the banker (who is usually technically an independent contractor, although he looks and acts like a staff banker to the outside world and in all other respects and may even be a firm partner). When he succeeds by closing deals around 50% of the fee goes to the banker and the balance goes to the bank and then after overhead expenses the remainder is distributed to the firm partners.

In this model, the bank is owned by the partners who fund the firm through good and bad times, providing the support staff, expensive research capabilities, and credibility that a real investment bank brings to a prospective client. The

house also provides the marketing and branding that are so necessary to successful Middle Market banking.

The problem, of course, is that while the EWYK banker is handsomely rewarded when he is successful (50% of say \$600,000, three times a year, is not a bad living by any standard), there can be long dry spells between deal closures, sometimes a year or more. For a banker who has been at it for awhile and developed some financial reserves, these dry spells can be unpleasant but not fatal. In my experience, it takes from one to three years for a new banker to gain enough traction that he can count on *completing* at least a deal a year, depending on his contacts and experience at the outset. This means that the only likely entrants to Middle Market investment banking—at least into the boutique EWYK system—will be older, more experienced persons with enough financial reserves behind them to survive the initial one to three years and enough life experience to not lose heart too soon.

I have seen some accomplish this by combining outside consulting work with investment banking for their first couple of years, but even this is problematic, because it can make the bank uncomfortable about its potential liability for the consulting work or even where the consulting work is coming from. Will the consulting clients assume they are dealing with the bank? Is the consultant able to attract his consulting clients because of his affiliation with the bank? These are serious issues. Credible boutique banks are NASD (since 2007 FINRA) broker dealers, for reasons I will explain shortly, and are required to be aware of and supervise the activities of their licensed bankers. An investment banker doing outside financial consulting work can pose a problem for the bank in that regard, and many would not consider allowing this approach for that reason.

## **Entry through a Boutique Firm as an Analyst**

An alternative entry point into boutique banking is as an analyst supporting the bankers with financial analysis, research, and memorandum preparation. This route at least provides a salary, an opportunity to learn, and the possibility of eventually graduating to becoming an EWYK banker with some kind of financial transitioning step. The problem here is that these jobs (unlike their counterparts on Wall Street, at least during the boom M&A cycles) are as scarce as hen's teeth.

## **Entry through a Larger Firm as an Analyst**

The other classic entry point for the younger person without financial resources is to pursue the larger firm route. The route here is usually again through the analysis and support group. Of course, in this case, the analyst may be handsomely paid, at least again in the boom M&A and financial markets years,

although job security can be a problem in the wane years. Something like 50,000 bankers and analysts were laid off with the financial and M&A markets collapses in early 2000 and a similar and certainly greater number in the fall of 2008. .

One disadvantage of this route is that, just as in the smaller versus big-four accounting firm situation, the employee of the larger firm will definitely tend to get less client involvement and may be relegated into the deep dark closet of a relative specialist. A great number of these young people in both professions tend to become disillusioned within a couple of years (not to mention burned out from the much, much longer work hours (often 90 or more per week) combined with less autonomy) and drop out.

## **Entry through a Consulting or other Professional Practice**

A third approach I have observed, and even in fact counseled on, is the addition of an M&A practice (a true investment banking practice, not a support services practice) to a consulting firm that has fees coming in from other sources to weather the inevitable bad times. Often, this will be a smaller CPA firm, a valuation practice, or even a law practice. These types of professionals have a step up in entering the M&A investment banking field, because they already have a handle on a few of the important technical aspects of M&A banking and have a potential client source as well from the other part of their practices.

My observation has been that these approaches have been mixed in their success. When they do not work, there are typically several reasons why. The problem lies in the very different cultural (Exhibit 30.1) and economic structures (Exhibit 30.2) of the investment banking profession (large fees but long periods of no fees at all) as compared to other types of business services firms (moderate but steady fees).

It is sometimes difficult to convince a partner in a CPA firm, for example, that his partner the investment banker should be drawing a paycheck during the long fallow periods when he is producing no income. However, when the banker produces a large fee after one of these periods, it seems it is just as tough for him to reconcile fee-splitting with his CPA partner when he is likely to feel that he has taken much of the big risk and should be rewarded with the biggest share of the upside.

This is part of the unfortunate side of receiving pay as large and infrequent sums of money, which is inherent in M&A investment banking but is nevertheless a fact of life. The differences that seem to emanate (Exhibits 30.3 and 30.4) from these two different cultures can cause no small amount of conflict between the two groups. The more highly competitive investment banking culture can and does

easily clash with the less competitive cultures of many business services firms. I have seen this bolt-on approach tried so far in law firms, consulting firms, and accounting firms. While I have seen a few real successes, the failures can tend to outnumber them unless they are handled properly—and properly usually means associating or partnering with a well-established M&A investment bank that can fund most of the costs during any fallow periods, without the need to divert the local practice from its main focus.

**Exhibit 30.2 Small Consulting or CPA Practice versus Sales-Side Investment Bank: Impressionistic Illustration of Key Financial Comparisons**

**Exhibit 30.3 Small Consulting or CPA Practice versus Sales-Side Investment Bank: Impressionistic Illustration of Different Approaches to Marketing and Business Development**

**Exhibit 30.4 Additional Skill Sets Necessary for Small Consulting or CPA Practice to Create a Sales-Side Investment Bank**

## **Lateral Entry from Firm to Firm**

There is, of course, the not uncommon practice of moving from firm to firm. I believe this may be more typical in the larger boutiques, where a banker's own referral base (such as the CEOs of a few large but M&A-active companies) can make him an attractive candidate for a raid or at least to get a better deal from another investment bank.

This illustrates again the fact that perhaps half of the professional goodwill in larger boutique practice resides in the bank and about half in the banker. Fortunately, it is rare for all the top bankers to leave at once. Then there is the occasional newer firm, where there is really only one significant rainmaker. But in this case, the firm will not be particularly stable unless that rainmaker owns it, which he usually does.

## **Insufficient Knowledge to be Successful**

An all-too-common assumption is that knowledge of one aspect of M&A (e.g., accounting, valuation, law, etc.) is fully sufficient to build a practice and competently advise clients. Each of these is a very good start, but only a start. The wiser firms and more successful consulting firms that have decided to foray into M&A have brought in an experienced M&A professional or investment bank to

establish the core expertise that they will need to enter this very different world from the one they are used to.

## Cultural Issues in Investment Banking Practices—Some Further Thoughts

M&A investment banking is concerned with large sums of money, whether that is the proceeds to the client or the banker's fees. Large sums of money, as it has been sometimes been my sad and sometimes my pleasurable experience to observe, tend to bring out the real people behind what is all-too-often the facade they present to the world. The facade may or may not be in synch with the real person, but I can almost guarantee you that large sums of money will bring that real person out, in synch or not. It comes out in relationships between bankers in the same firm in the form of overcompetition to claim referred deals or quarrels about fee splits.

I suppose this is inevitable. I can already imagine some moralistic reader shaking his or her head knowingly while uttering something like "Those greedy money people." Actually, though, I think the competition here is no more or less intense than what is found in most, perhaps all, human pursuits, ranging from art to love, to science, to business, and so on. The difference is that the financial stakes, at least, can often be higher. In my opinion, it is very difficult (and unlikely anyway) for a *single* banker to close and manage more than three transactions a year. So when a dispute does arise between bankers, it may be over as much as a third or more of the banker's income for that year. This is enough to make anyone competitive. Add this inherently high-stakes competitiveness to the fact that bankers are people who are used to negotiating and more keenly aware than many others of the day-to-day tendency for people to prefer and rigorously defend their own self-interest, and voilà, you have a very competitive environment. It is critical to document any banker-to-banker fee split arrangements in detail and well in advance, and to at the same time remain flexible should circumstances warrant that the fee split be revisited. But any such changed circumstances need to be big ones.

As I said, I do not think bankers are unusual here, and much of this is due to the context in which they find themselves. To be successful in Middle Market investment banking also requires having social skills that cannot really be faked over time. The relationships in the Middle Market between bankers, their clients, and their colleagues is just too close to allow a banker with bad people skills to

survive long. What I am trying to say is that usually these are nice guys and gals, in spite of the highly competitive environment.

Furthermore in my experience the culture of an M&A firm can be tremendously influenced by its leadership. If the partners, or at least principal partners, appear to be meticulously fair and always above reproach in terms of honesty and integrity that culture will permeate down through the firm. This does though have to be combined with the partners willingness to quickly identify and remove any sour apples in the firm in this regard. It is easy enough to poison the entire apple barrel without decisive movement in terms of behaviors that are expected and others that will not be tolerated.

## **Teamwork and Mitigating Risk**

The partners in Middle Market banks should go to every length possible to encourage, without mandating (some bankers, some very good ones, just will not be comfortable with this), teamwork on client engagements. This goes a long way towards neutralizing the natural competitiveness among bankers. In addition, the team approach not only builds relationships between bankers but also smoothes out the economic peaks and valleys inherent in Middle Market EWYK banking systems.

When two or more bankers split the 50% banker side of the fee, it engenders a sense of responsibility on the part of the banker who was invited into the deal (there is almost always a clear lead or initiating banker—typically a firm rainmaker—who was responsible for bringing the deal in house) to act in kind in the future to the banker who brought him in. In my own experience, when this type of system is introduced into a firm, it is met at first with a bit of reluctance but thereafter it is amazing how quickly most of the bankers begin to accept the team system and even come to rely on it as the best approach.

I mentioned before that in my view, it is very unlikely that a banker can manage more than three engagements in a year, especially all at one time. The team system greatly mitigates on behalf of bankers and their clients. The problem with the deal business is that it is lumpy. Engagements do not come off of conveyor belts neat and orderly, one deal at a time. They come in clumps and slumps. This is equally true about a deal's phases and stages. In the semifinal and final stages of a deal (the auction and the final LOI through closing), the time involvement on the part of the banker can be incredibly intense. In fact, when a banker is involved in two of these at the same time, he will have little time to do anything else, like develop more business (which I will talk about shortly) or even handle day-to-day human issues like vacations, illnesses, and family

responsibilities. The team system obviously aids with this aspect of lumpiness during deal execution phases too.

The benefits of the team approach include the enhanced quality of service provided to the client. The client is happy because there is always coverage, and happy clients of course enhance the firm's and the bankers' reputations and referrals. But as I said, in the firms in which I have been involved in the management, I have never found it necessary to mandate the team approach. Most bankers, when they get a little experience, just simply prefer it. The occasional banker who insists on keeping all of his deals to himself had better be very good at both business development and deal management. I do not think many bankers can survive the Middle Market lumpiness as loners.

## **Financial Risks—Other**

If I have not made it clear previously, Middle Market bankers can make a lot of money, or . . . not. If they do, it is only by taking on great risk. The risk is working very, very hard and ending up with no payday. The banker takes on myriad risks. But mostly, he takes on the risk that the deal will not get done.

Not many professionals will accept an assignment that may take up to a third to a half of the working year with no reasonable assurance of a significant payday of any type. How does one get that reasonable assurance? Bankers learn eventually to be very careful about the projects they take on. The opportunity costs of working very hard on a deal that cannot be closed for the sake of a small retainer are huge. It does the banker any good in terms of his reputation, either, to take on deal he cannot complete for some reason.

A good rule of thumb, perhaps, is that a banker should have a confidence level of about 75% that he can get a deal through to the finish line. If 75% does not sound very high to you, well, it does to me. In fact, that is about as high a confidence level as is sane to have at the onset of an engagement. Even if the banker has thoroughly analyzed the client's business, the opportunity for deals in the client's industry, and so on, there are so many reasons that a deal might not be done that are out of the banker's control that in my opinion, 75% is a decent confidence level.

The longer a transaction takes, the more things can go wrong, such as marketplace changes, for example, and force majeure. I completed a transaction for a client in early June 2000 that resulted in a sale of his small telecommunications engineering support business for \$38 million. He and I got in just under the wire. Had he not done the transaction then, within two months his business would have been virtually unsalable. The telecommunications crash was about to hit, hard and suddenly. The frenzy to lay thousands of miles of cable across the country, soon followed by overcapacity, came to a very quick end—and

so did many of the business that served the telecommunications revolution and that had been incredibly attractive acquisition candidates just months before.

While I fortunately did not have the personal experience of losing a deal in the wake of September 11, 2001 (you do escape a few bullets, I guess, in spite of yourself), I can tell you that many, many financing and acquisition deals were put on hold or entirely cancelled as a result of the terrorist attacks. This phenomena is recurring even now as I make the final edits to this book in the Fall of 2008 in what will undoubtedly be recorded in history books as the “Great Crash of 2008” or something similar. Deals in excess of \$75 to \$100 million dollars are starting to get very shaky as financing debt dries up and public company buyers especially, are reluctant to make serious economic decisions. Whether this will be very short term is difficult to say but it too will pass.

There are endless other reasons for not closing that have nothing to do with the quality of either the business or the quality of the investment banking services. These reasons range from divorces to deaths to clients simply changing their minds. I believe that if these factors are taken out of the equation, one could realistically estimate the odds of success on most well-vetted sales-side engagements at 90%, but these extraneous factors are very real, and anyone considering Middle Market investment banking as a profession should be aware of them so as to allow some reasonable personal budgeting decisions as well as some emotional preparation for those occasions when these things not infrequently happen.

The first financial risk taken on by bankers is at the start of their careers. As I have said, a large number of Middle Market banks operate on an commission-only (EWYK) basis with their bankers. Combine this with the fact that it would be very unusual for a banker to actually *complete* a transaction during his first 18 months in practice, and you have some risk that he will run out of money and have to find other work just at the time when he is reaching the tipping point for the actual start of deal flow, which I believe is usually around 18 to 24 months. The gestation period for M&A deals and client relationships can be years, and of course, even after the banker is engaged, it can take six to twelve months or sometimes a lot longer to close a transaction.

## **Marketing: Half of Investment Danking is Business Development**

As I have said before, the irony of this business is that the more successfully you represent a client on the sales-side, the more quickly you lose him as client. While he is drinking umbrella drinks in South Florida, you are left

with the satisfaction of having done a good job and the problem of where your next client is going to come from. I spent some years in the 1970s building a rather substantial public accounting practice. It was my experience that once you had a client on board, the stickiness of the relationship was powerful. You had to really do something bad to lose a client. As a result, the need for practice development, while it was there, at best needed to take up no more than, say, 10% of the accountant's working hours. It may be more now but really not that much except for a few senior business development partners.

That simply is not the case in investment banking. It is more realistic to assume that something like 50% of a banker's time at all levels of the firm will be spent developing new business if he is to be successful. Unlike public accounting or some consulting practices, there is little or no annuity feature to investment banking beyond the gradual building of a reputation for the bank or banker. The associated problem is that while a banker is executing deals, especially if he is working on more than one at a time, he is unlikely to have much time to develop more business. This is another way the banking business is lumpy and why it is critical to combine drip marketing (constantly staying in front of a lot potential deal flow through emails, snail mail marketing, and the like) with heavy continued personal networking. I recently heard one of our bankers describe this relationship as in a war metaphor the air force (the drip marketing) and the ground troops (local continued personal networking). Neither works very well without the other but when they are done together one plus one is greater than two by far. I guess "Force Multiplier" would be another apt war metaphor.

## **What a Banker Markets versus What He Sells**

Assuming a banker is focused on the sales side, another issue is concerned with what a banker is trying to market when he develops business. Middle Market decisions to sell are only occasionally motivated by an investment banker. There are some exceptions, of course, and occasionally the market situation in a client's industry will be either particularly conducive to selling or particularly threatening enough to warrant considering a sale at an investment banker's recommendation. However, an investment banker usually has little influence over when a client might decide to sell. The banker can supply information, but the client makes the decision—often for non-economic reasons.

Most of the time, decisions to sell are made independently of the banker, whether they are for business or life situation reasons. So what a banker markets, when developing business, is ability to represent the client with excellence, in ways that are better than those of the competition. Since the banker has little influence on the timing of a prospective client's business sale, he or she will need to follow a business development approach that will put him/her in the right place over and over again, trusting that one day it will also be at the right time.

This approach suggests that a banker has to be in front of a lot of possible clients or referral sources in a year. Exhibits 30.1, 30.2, and 30.3 illustrate impressionistically at least the effort needed by a small investment bank to maintain, say, two to ten transactions a year. Obviously, when I use numbers like 17,500 contacts to net 10 clients (keep in mind that even all of these will not result necessarily in closed deals), I am being impressionistic, but I can tell you that it is an impression based on long experience and many conversations with other bankers over the years. In fact, I have seen similar numbers estimated by another quality investment bank.

## **Sellers, not Buyers**

If it is not obvious already, let me make one comment in the context of marketing and business development for sales-side bankers, to those who would enter these portals:

You are marketing for *sellers*!

Hopefully, that makes the point. Among the most frequent misperceptions I see in beginning investment bankers is the excitement they show when they find or have been approached by a buyer. It does not matter whether they have a sales-side client or not, just that they have found or been approached by a buyer. This is a lot like finding a pickaxe and thinking you have struck gold (assuming it is not a buyer willing to pay a retainer<sup>3</sup>). I cannot imagine anything less exciting to an experienced Middle Market banker.

Buyers are simply not the problem when it comes to obtaining new business for an investment banker. Unless he emphasizes buy-side retained work, the Middle Market investment banker's focus is sellers, unlike business brokerage offices in the Mom-and-Pop world, in which buyers are almost as highly valued. Once a sales-side client representation is undertaken, the issue is certainly one of finding buyers, but in a sales-side engagement, well-vetted, the buyers will come readily and reasonably abundantly. In fact, the very nature of the negotiated auction process is such that, unless desperate, the last thing a banker wants is a single buyer. With a good sales-side representation, a banker wants and should be able to find multiple buyers.

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<sup>3</sup> While this book is sales-side focused, I want to make a distinction of course between the passive buyer, who simply announces he is available to purchase the right business, and the active buyer, who is willing to pay a retainer for an acquisition search.

# Multiple Marketing Approaches

Among the possible approaches to the dilemma of the very large numbers of contacts necessary to achieve a very small number of engagements and then to get in front of these clients at exactly the right time through networking, drip and brand marketing. I believe the following are the best approaches, at least that I have found.

## **Becoming an Expert in an Industry**

I believe that this is one of the most effective ways for an investment bank or a banker to achieve solid success, hands down. If he goes about it the right way, it suggests all kinds of opportunities to put himself in front of a large number of potential sales-side (and retained buy-side, for that matter) clients at exactly the right time. It is surprisingly easy to both actually become and be perceived as an expert in an industry. At a minimum, four things are necessary:

### **Initial Research to Understand and Choose the Industry**

It is key to find the right industry and there are some things to look for in determining which industry (or industries) on which to focus.

First, it should be an industry where there is a lot of churning, things are changing, companies are consolidating. Frequently, this has been in the second wave<sup>4</sup> of technology industry acquisitions, with a few dominant players fighting each other but an otherwise fragmented industry with a lot of second-tier players who have enough good technology or business to be of interest to the dominants. An industry where the dominant players have already achieved enough dominance that the secondary players would be of little interest to them would not, of course, be a good choice.

Another consideration is the amount of banking coverage that an industry is already getting. Frankly, I have rarely found an industry where there is no room for one more investment banker expert. I suppose it is possible, but I think if that is the case, the churning cycle is probably toward the end anyway—which is the real reason to seek other opportunity industries in which to specialize.

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<sup>4</sup> The second wave of technology industry acquisition, seen from the perspective of my firm, has been with companies where the emphasis is not so much on technology per se, as it was in the mid- to late 1990s, but on business solutions applications. In many vertical industries, transportation and hospitality for example technology is no longer so much gee wiz stuff as it is real solutions to real problems such as optimizing hotel room bookings or airline seat sales. In each of these technologies while there are a few dominant players there are a number of secondary players too with great technologies and/or enough business to be attractive acquisition candidates to the dominants.

Finally, it is important to pick a narrow enough niche. For example, specializing in “technology” would be far too broad now, although it might not have been 15 years ago. One would need to specialize in a subset of technology, like health care technology (and even a subset of that, probably), financial operations software, or a clear subset of telecom technology.

### **Publication in Industry Trade Journals and via the Internet**

Investment bankers should demonstrate their knowledge of the specialty niche by drafting two to four articles or perhaps a white paper a year for publication either in industry trade journals or via broadcast email to a select database of industry players.

Interestingly enough, I have found this requirement to be somewhat intimidating to bankers. What will I write about, and where will I get the data? In the age of the Internet, data is more than abundant: The problem will not be finding it, the problem is more like being overwhelmed by it. A good concept to use in considering content for your articles is “News You Can Use.” Think about what you would like to know in your own industry. All Middle Market businesses have great curiosity about what they might be worth; what other deals are being done; what the state of industry consolidation is; and so on.

This information is abundant and does not even require that much original research, to be perfectly honest. Having said that, however, there is nothing quite like original research, which usually means meeting, talking to, and getting to know the people in the industry. Everyone likes to talk to investment bankers about the subjects that interest them; namely, their money and their opportunities, their industry trends and their competitors. Remember that using others’ independent research requires citation and attribution, but there is no shame in that. And avoid merely rearranging facts that are in the public domain (your readers can use Google, they have probably read it already). Your article should present information with a compelling new focus, drawing conclusions on or synthesizing the research you have done in a way that’s interesting and unique. **I**

Another thought to use in helping stimulate a banker’s creativity is to think in terms of your opinions. I have known very few bankers who, no matter how shy they might be about writing, are unwilling to express their opinions orally, loud and clear. So do it. Just do it in writing. Do it conversationally. Do not at all worry about editing the first time through. You or somebody else can do that later. Just talk. Anne Lamott, in her great book *Bird by Bird: Some Instructions on Writing and Life*, suggests that writers be tolerant of their “shitty first drafts.” If professional writers can be tolerant of putting down essentially what they are thinking, and then get around to organizing and pruning it later, so can the rest of us. If all else fails, hire a ghost writer. Chances are, if you have been studying an industry for even a short while, you will have developed your own opinions even

if you cannot immediately cite the data to support them. Write your opinions down first, and then either you or somebody else in the firm can supplement them with research where it is needed. Generally, if you have made a thorough study of your specific field, you will find that the research matches your views. Why? Because you have probably acquired those views from careful observations and your own reading. Even if the research proves you to be wrong, that itself is terrific, as it brings even more focus to your industry knowledge.

If a banker can publish two or three articles annually, in combination with the other approaches to developing industry expertise, he or she will soon be the “go-to” banker (or at least one of them) for people in the industry.

### **Development of an Industry Database of Players**

Once again, this is a project that takes more time than skill—and probably not even that much time to create a basic list. There are abundant sources of lists of the companies involved in any given industry. These range from attendance lists at trade shows (see below) to purchasable lists from publications, trade associations, and services that sell lists. One thing is certain; If there is an industry, there is someone, somewhere, who has compiled a list of its players. On the other hand if no one has then be the first to do it.

This database will provide the source of addressees for self-published articles and also put some boundaries around the industry universe, which will come in handy in future research and just day-to-day contact information. If email is used, then good judgment would suggest that the emails contain graphics and articles of high quality, be reasonably spaced out (once a month would be the maximum), and provide the addressees with a clear way to opt out.

### **Attendance at Trade Shows or Industry Conventions**

To develop and establish your industry expertise, it is critical to attend at least three or four trade shows or industry conventions a year where the players themselves gather. And that does not mean simply visiting exhibit booths to see what is going on. Two bankers with whom I have had the pleasure of working are quite skilled at this approach. They are “Energizer Bunnies™” when it comes to this technique. One of them sometimes rents a suite or small comfortable meeting room and, well in advance of the convention, invites carefully selected people, such as CEOs and officers of companies in his industry, to meet with him (usually sequentially, as these are often competitors). He has excellent success, usually having a dozen or so meetings in two days.

Another banker with whom I have attended industry conventions in his field of specialty is exhausting (and educational) to be with for two days or so when he is doing his thing there. He goes nonstop, maximizing every opportunity to get into a dialogue with the businesses officers. And it does not have to be the

CEO. He often establishes substantial leads, for example, just by contacting the CIOs, who in the smaller technology firms are likely to be at the shows. He walks the aisles and they are flattered.

So what do these guys say? What kind of conversations do they have? Well for the most part, they just talk investment banking relative to the industry and the prospective clients' business. As I said, it is a rare CEO or owner who is not interested in the state of the industry, what his company might be worth, what his competitors are doing in the M&A arena.

If the banker has also established himself with published articles, he will most certainly have a high success rate in getting the ear of the right people. My observation has been that after a couple of years of this kind of sustained effort, a banker can just walk into the door of a trade show in his industry, stand there, and they (the industry players) will come to him.

## **Specialization Takes Time**

Achieving that stature in the chosen industry does take some time, though. Bankers I have observed and talked to, who have followed this approach, suggest that the real payoff begins around two to three years out. But when it comes, if the industry is chosen well and the follow-up is good, the payoff will be handsome. Keep in mind that the two principles of investment banking prospecting are to be there at the right time and to convince the prospective client that you have the skills sets to execute his investment banking transaction. There is no better way than industry specialization to do this.

## **Specialization is Not Without Its Dangers**

Specialization can be a risky strategy, though. The ebb and flow of M&A industry sectors are notorious. In Chapter 6, I talked about the problems of timing the sale of Middle Market businesses and the certainty that industries have their cycles. Add to this the macroeconomic cycles that also impact M&A activity, and you have a double whammy that suggests that putting all of your eggs in one exclusive basket may not be an entirely good idea.

It is the “live by the sword, die by the sword” approach. If your practice specialty is in an area that is experiencing either a valuation bubble or a great deal of activity (usually these two features co-exist), then all is well and good . . . until the bubble is over. Correspondingly, M&A activity closely tracks the macroeconomy, and when the latter is off, it is far better to have several practice areas to draw from in a period when there are overall fewer deals. A judicious approach, for an individual banker at least, is to blend perhaps one or two practice specialties with a general Middle Market approach.

From the perspective of an investment bank, the same thing is true. If for example a bank has ten bankers, each of whom pursue one specialty as well as a general practice, then the bank is somewhat insulated from the slings and arrows of bubbles and cycles in industries, and at least somewhat better insulated from macroeconomic slumps as well.

Finally, the number of industry specializations a banker can take on is limited by resources of time, money, and focus. Committing to write three or four articles (an absolute minimum necessity) and attend three or four trade shows (again, probably an absolute minimum) is a significant commitment of time. Multiply this by several specialties, and the time and money commitments grow rapidly. Then there is the traditional conflict between quantity and quality, which must be taken into account.

All in all, it will depend on the circumstances of the bank and the banker, but I seriously doubt, in a small boutique (ten or fewer professionals), that more than one or two specialties per banker is reasonable. Too many specialties will overly stress your resources and focus, making the strategy counterproductive.

## **The New York Banker Style of Practice**

There is another style (a somewhat cinematic one admittedly) of what I suppose you could call marketing, and that I call the New York Banker. This banker is the type who more or less creates deals out of whole cloth. He keeps his ear to the ground in one or more industries, for example, learns where the right M&A combinations might be, and between whom, and tries to instigate a deal between two parties who did not anticipate being in a deal of any kind at the moment, much less with each other. By patiently pointing out the advantages to the heretofore clueless parties, the banker gets something going.

I have seen more than one Middle Market banker succeed very well with this approach, but it really takes a lot of knowledge of an industry or sector (without otherwise specializing in it) and reading a lot of general business media to boot. I also think it takes a certain type of very aggressive personality. I admire the style, but I am not particularly comfortable with it myself.

## **Being in the Investment Banking Business for a Long Time**

This approach may seem rather obvious, and I would not mention it here but for the fact that it illustrates a little differently what I was saying about entry points into Middle Market investment banking. The difficulty in entering the business is largely associated with the length of time it takes to build a following

and a reasonably reliable stream of engagements. This is true for individual investment bankers and for new banks. The pleasant outcome of long-term involvement in M&A is the fact that, having survived the early years, a bank or banker can be reasonably assured that transactions will come along. Maybe not as often as he would like, but often enough, especially when associated with the other active business development approaches that I am general discussing here, to be very rewarding.

A lot of this comes from building a reputation as a name in the business. Clients want to see that the firm is a player, and an experienced one that has been around for a while. When a firm has been around for a while, it is likely prospective clients will become aware of it from just sheer endurance. The marketing people call that “branding.”

## **Covering Large Numbers of Middle Market Business Owners**

Exhibits 30.4 and 30.5 illustrate, at least impressionistically, the problem faced by the Middle Market investment banking industry, and that is the need to be, and the effort required to be, in the right place at the right time. Hiring an M&A banker is not like weekly grocery shopping, where the vendor just puts up a store and waits. For many Middle Market businesses, their sale is a once- or twice-in-a-lifetime event. The banker must be there when the need arises. All of the tactics suggested here are different approaches to that idea, but at its simplest level, the law of just being visible in front of large numbers of prospective clients is an effective and critically necessary approach.

During its heyday, a once-well-known Middle Market bank—some would call it more of a business brokerage firm than an investment bank (and it was sometimes well known for the wrong reasons)—sent out vast quantities of direct snail mail pieces to net thousands of potential clients a year.<sup>5</sup> Admittedly, this was viewed by many as an approach that was more focused on selling valuations for relatively large retainers than on quality investment banking, but it does suggest that the practice of contacting large numbers of potential clients can be effective. Unfortunately, it is also estimated to have only closed 10% of its clients’ transactions, with almost 90% of its revenue coming from retainers (valuations) as opposed to success fees. But that was its style—it need not and *should not* be yours.

A number of legitimate investment banks, especially in the 1990s, took the same approach (mass mailers and seminars); some still do. Although it reached a saturation point in the late 1990s, and the activity level eventually dropped, particularly after the economic crash in early 2000, the approach can be effective if done tastefully and consistently over a long period, perhaps using the more

modern approach of broadcast email (preferably with opt-in and opt-out alternatives for recipients who might consider this spam). These mail contacts do not have to be overt solicitations of clients, but can include invitations to seminars with other interesting news that will hopefully garner the attention of Middle Market business owners, who are always interested in keeping abreast of issues that concern their eventual exit strategies and/or their industries.

For example, in my own extended metropolitan area, there are approximately 5,000 Middle Market businesses. Staying tastefully in front of them ten times a year (50,000 points of contact) is simple enough and can be accomplished very inexpensively by using the broadcast email approach. While not all of these e-mails will be opened (15% is a good estimate) it works better than direct snail mail where the estimated action rate is about 1%.

Combined with two educational seminars<sup>5</sup> a year (advertised with very tasteful graphics, and including real educational content), this approach can be very effective in terms of being in the right place at the right time and demonstrating that your bank is the one to represent the client when they are ready.

## Networking in General

Let me just say this once: Networking, done properly, is *the single best way to develop business*. Over many years of observing bankers, I have without any doubt observed a direct correlation between success and the amount of quality networking. By doing it properly, I mean:

1. *Make it a discipline* by scheduling a certain number of organizations and individuals to network with each month and each year. Anything less than once a week is less than wholehearted and less than effective. Keep a recurring list, and stick to it—sometimes over many years. This is another aspect of being in investment banking for a long time.
2. *Get involved in organizations*. Do not simply attend organization meetings. Get involved. Join committees. This is the way to develop close relationships with people, by getting to know them and

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<sup>5</sup> The national brokerage firm combined its huge national direct mail campaigns with what were reputedly very high-pressure scare-tactic seminars in very poor taste. This approach backfired as often as not, at least with the more intelligent attendees, but it also obviously landed a certain number of the gullible (and often greedy) types. The whole operation was more than a little distasteful and should hardly be dignified as investment banking. It was subsequently purchased by a large reputable national firm in the financial services industry, which has been cleaning up its act. Much of my information comes from conversations with former employees of the organization.

working with them. Direct selling is unnecessary most of the time. When people know who you are and what you do, and they like you, they will refer business to you. Period.

3. *Maintain a list of contacts.* Drop them a note from time to time. The note does not have to be associated with direct selling of your services—and most of the time, it should not be. A simple “Happy Birthday” or “Hi, how is it going?” note is much better. Nobody wants to be plagued by self-promoting salesmen.
4. *Avoid the business card handout* kind of networking above all. Most people will throw these away and forget you if you restrict your networking to this style.
5. *Do not restrict your networking to business organizations.* Business people are often involved in charitable and arts organizations. Go where they go. Get involved.
6. *Be patient.* This approach takes time, but success here, while gradual is exponential as opposed to arithmetic.

## **Networking with Professionals who Provide Services to High Net Worth Clients**

This can be an effective approach, although as usual there are potential pitfalls. Money managers and similar wealth management professionals often have a high net worth clientele, and, quite naturally, a number of that clientele are going to be Middle Market owners or executives. While this approach is very similar to networking with other M&A support professionals (see below), the thing to be aware of is that this class of professional sees M&A intermediaries through the opposite end of the lens. They see intermediaries as being a lucrative source of referrals back to them. After all, most Middle Market M&A business owners, having just completed a sales-side transaction, will likely be more liquid, more affluent, and more in need of wealth management services.

## **Networking with Other M&A Support Professionals**

Accountants, attorneys, commercial bankers, business consultants, and valuation professionals can obviously constitute a good referral base (but see my caveats at the end of this section) for the same reason that wealth management professionals can. They also look at M&A bankers from the other side of the lens as potentially a good referral source back to them, as do wealth managers.

In truth, we are. I would say in perhaps one third of the transactions we encounter in my own practice, we are in a position to refer a client to at least one of these professional groups (with the exception of outside valuation experts, as they have little to do with M&A transactions once one has been initiated).

The ability to refer to attorneys, for example, usually arises from the fact that many sales-side clients would have had no reason to have a relationship with a transaction attorney and are seeking our advice in finding a good one. In the case of accountants, a similar situation arises. A surprising number of Middle Market businesses with well to the north of \$10 million in revenues are able to get by with maintaining a fairly casual accounting system (at least some aspects of it) and are not necessarily audited either. About one in two transactions will see the client raising the level of pre-transaction accounting services to avoid confirmatory due diligence problems and perhaps to increase the quality of their tax advice.

Accountants and commercial bankers are likely to be able to refer business, as they will sometimes know about a client's transaction before the client hires an investment banker. Attorneys, on the other hand, even more often learn of the transaction before the banker has been hired, and are a worthy referral source to cultivate. But an investment banker's ability to refer to a commercial banker is somewhat limited by the fact that the sales-side investment banker's objective often is to put his or her client out of business, but many commercial banks now have affiliated wealth management services of one type or another, and will be interested in the referred client's newfound liquidity.

My point here is that M&A bankers can be a very good referral source for these support professionals and, as such, can expect to receive referrals back. These guys are a major source of investment banking business over the years. There is another side of the coin, though: In my experience, many of these wealth management and other M&A support professionals can promise a lot and deliver little. In my own firm, we allow these professionals to address our bankers periodically, as a small part of our staff meetings. In many cases, we know that these professionals have addressed every other M&A bank in the last year as well, looking for referrals themselves. Who is likely to get the deal referral when it comes? Beats me!

And it is fair to say, too, that this is a problem for both sides. One thing that I believe is critical to understand in developing a referral base is that the old 80/20 cliché comes into play here quite handsomely. About 20% of the referral base you develop and cultivate over the years will produce about 80% of your referrals.<sup>6</sup>

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<sup>6</sup> While it may have become a cliché, the 80/20 rule is actually yet another possibly observable instance of the Pareto Principle, sometime known as the Law of the Vital Few, developed by Italian economist Vilfredo Pareto. Whether this can be actually observed in this instance, I am not sure, but I can tell you that in a professional career of some length it feels very, very consistent with my experience.

One learns quickly to recognize or at least sense the ones with whom, for one reason or another, you will develop a strong mutual referral relationship that will last through the years.

I am always very friendly (but internally skeptical) on meeting new referral sources. I am also very up front about discussing the 80/20 rule. There is no reason not to. It is true, and everybody knows it. The final rule I follow religiously is to treat those with whom I do develop a mutual referral relationship as very special. A sacrosanct rule is that if we receive a referral, we find a way to reciprocate. That is called “fertilizing the plant,” and it is as effective in business as it is in agriculture. I am always amazed at the unfocused “everywhere, all the time” networkers I see; they seem to be trying to be all things to all people. They would be far better served to focus over time on the quality of their referral base, not the quantity.

A corollary to this is the fact that investment banking referrals are not going to come in large numbers as a rule from any one referrer. If I received one transaction referral every three or four years or so from my top ten referral relationships, I would have an incredible deal flow from just this one source. Again the idea here is consistency, not quantity.

## **Long-Term Exit Strategy Planning**

Another approach to developing business stems from the combination of understanding that:

- Developing trust and confidence with a client can take a long time.
- Middle Market M&A engagements, unless caused by quick necessity of some sort on the part of the client (death, divorce, catastrophe), frequently can have a long gestation period or sale cycle.
- Almost all Middle Market businesses would do well to begin planning for a sale at least three years before executing it.

All of which leaves an opportunity to actually develop a sort of subpractice of exit strategy consulting, which can not only be lucrative in its own right but also can provide a long-term pipeline of deal flow into the future.

One successful method I have observed (and have practiced in my own firm) is to obtain a consulting engagement with a Middle Market client that begins with a preliminary valuation, giving a detailed analysis of the client’s business value drivers that the client, in turn, can use to reverse-engineer his company by knowing what will eventually bring about its maximized value when the time for a sales transaction actually arrives. We have found it helpful, in formulating these engagements, to include periodic pulse-check meetings and often, as well, to give

a credit to the client for some of the fees paid to us against the eventual retainer when the sales-side engagement takes place. In this case, the credit that is, the client actually has an investment in the banker.

## **Serving Clients and Executing Engagements Well**

Over the years, investment banks, like other professionals, develop whatever reputation they earn. A client I represented a number of years ago, a small international consulting practice, came up with the concept that an irritated client is far more damaging than a pleased client is helpful. This concept might be self-evident, but like most self-evident principles, nobody had quite expressed it the way my client did. The consultants, based on studies, learned that an angry client or customer will tell about eight people of his unpleasant experience, whereas a happy client or customer will tell only two people. This knowledge not only spawned a very lucrative consulting practice, but also had a profound impact on the way many, many large American, Japanese, and eventually other businesses came to approach the issue of quality of services and products.

### **Performance and Intensity in their Clients' Interests by M&A Bankers**

Investment banking results are a very big ticket item for clients. If you want to really irritate somebody, do something to his pocketbook. But if you want to create a friend and a referrer for life, perform for that client like there is nothing more important on this Earth at this moment. Live the transaction with him. Let him know you are fighting for him as if your own fortunes depended on it (of course, they actually do).

I have clients I have been using as references and referral sources for more than ten years. They will not hesitate to spend 30 minutes sometimes talking to a prospective client for whom I have used them as a reference. I am not going to suggest for a moment that you can be in practice for many years and have every client you deal with be exceedingly happy. There are always characters and problem clients out there, as well as clients who will tend to externalize their own self-created problems on you. However, a banker's goal should be to please 100% of his clients. If he is successful 90% of the time, he will eventually have a constant source of deal flow and a referral base to support his deal flow.

**Richmond, VA—October 1991**

“Give me an example of what you mean by intensity, Doug, since you talk about it so much.”

Doug, a really successful Middle Market banker, and I were sharing a very bad and unhealthy fast food lunch in the front seat of my car. We were really in a hurry to get down to the Norfolk area in tidewater Virginia for a meeting with a food industry client, and it was the best we could do for lunch, I am sorry to say.

“All right, this is what I mean. Do you remember that food distribution deal that closed several months ago?”

“Sort of.”

“For two days before closing, I tromped around that damned warehouse observing inventory counts, because my client’s accountant was not available, everybody was shorthanded, and the inventories needed to be completed if we were going to be able to close. You have any idea what it is like to be in a 15-degree refrigerated warehouse counting frozen food packages?”

“No, never done that.”

“Well, the deal got closed. I got a really bad head cold, and . . . the client sent me a referral a month later. Guess it was worth it.”

“Guess it was. I see what you mean.”

Like all of the other anecdotes in this book, this one is true, if slightly altered to protect the innocent.

### **Exhibit 30.5 Impressionistic Illustration of Best Practices Annual Marketing and Business Development Strategies for an IB**

## **Securities Law Issues**

Under the Securities Exchange Act and the Uniform Securities Act (which is more or less a codification of or basis for many states’ blue sky laws), it is clear that the solicitation for the sale of securities is subject to regulation. In the great stock market crash of 1929, approximately \$25 billion dollars of securities became worthless, the Great Depression ensued, and the Securities Acts of 1933 and 1934 quickly followed. The primary thrust of both of these acts is fair treatment of investors, which requires full and adequate disclosure.

All sales of securities using interstate commerce must comply with the regulations. These regulations are generally administered by the National Association of Security Dealers (NASD); since 2007, the name of the regulatory

body is the Financial Institutions Regulatory Authority (FINRA). This self-regulating professional body is under the not-too-far-distant oversight of the SEC.

Part of the actual administration takes the form of requiring individuals involved in this type of work to have a securities license, thus becoming registered representatives. The most common licenses held by M&A professionals are Series 7, for federal purposes, and Series 63, for state purposes.

The investment bank itself is required to be a *broker dealer*, subject to a great deal of regulation designed to protect the public. The broker dealer is required to file quarterly financial reports and annual audits, and is held strictly accountable for maintaining minimum levels of capital.<sup>7</sup>

In addition, one or more of the partners or members of the firm will have to hold Securities Principal Licenses (Series 24) and, unless they hire it out to a consultant, a Series 28 license as a financial operations principal (Fin-Op). Although the Fin-Op license is by no means a piece of cake, especially for non-accountants, none of the licenses is beyond the ken of the average financial professional. However, a week or two of serious study and testing can be anticipated for each of these licenses.

The sale of securities in an M&A transaction under both federal and state securities laws is clearly covered, but it is doubtful that Middle Market M&A activity was originally even thought of when the regulations were put into place.<sup>8</sup> The problem is that far more than 50% of Middle Market M&A transactions involve the acquisition of the owning entity's stock, particularly since the 1986 tax act, which made the sale of entity assets prohibitively expensive due the fact that they are taxed twice, once at the corporate level and then later, after distribution, at the shareholder level.<sup>9</sup>

Penalties for selling securities can be both civil and criminal and can also result in rescission of the transaction. Of course, transaction rescission could also

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<sup>7</sup> Assuming that the broker dealer is set up strictly for executing M&A transactions, it can expect to satisfy the requirements of minimum capital by maintaining no less than \$6,000 in equity capital at any time. This can be more complex than it sounds, as this capital requirement can be affected easily by other balance sheet debt.

<sup>8</sup> As of this writing, there is an ABA task force (June 2005) report recommending at least somewhat more sensible regulations regarding an M&A type of practice. Furthermore, certain M&A industry groups are taking a harder look at this. Hopefully the SEC and the FINRA will see the light eventually. The biggest problem is that there are 50 states that would have to buy in to and serious change in the regulations and that why this process is likely to take a long time.

<sup>9</sup> This assumes that an S corporation election is not in place, of course.

lead to lawsuits, to which the unlicensed banker can be certain he will be a respondent when they are filed.

Another real problem is the sales-side client who deals with a fee dispute with his banker by threatening to point out to the authorities that the bank was inappropriately conducting regulated activity without being properly licensed. This has caused more than one non-licensed M&A bank to walk away from or quickly settle a large fee that they had otherwise well earned.

For these reasons, many unlicensed investment banks took the leap in the late 1990s and became broker dealers. While it is not clear that this is a necessary step (ask ten law firms prior to the last five years or so and you would have gotten varying opinions<sup>10</sup>) many banks went forward anyway, in an abundance of caution. Now, for many of the better banks, it has become the norm.

I also believe that many of them found that getting properly licensed had the additional favorable consequence of adding a level of credibility that their unlicensed competitors might not have, giving them somewhat of a competitive advantage. What is clear is that the regulators really do not quite know what to do with these “strictly M&A” banks. They enforce the regulations as they must, but with seemingly little relevance to what the laws and regulations originally contemplated (again, the sale of securities to the public). It would not surprise me if a separate set of regulations eventually evolves to cover “strictly M&A” banks. Several drafts by the American Bar Association have been submitted to the SEC already. They are badly needed.

My last comments on the regulation issue:

- Consider establishing the broker dealer as a standalone entity that only deposits fee checks and disburses fee splits, with no other expenses running through it. This will make the auditing and minimum capital complexities much easier to administer.
- Establish an expense-sharing agreement that allows the main consulting practice to guarantee the expenses of the broker dealer. These arrangements have been approved by FINRA, provided that the guarantor has the capacity to actually guarantee the expenses and that a careful record of the appropriate allocable or direct expenses is maintained.

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<sup>10</sup> Some law firms, for example, advised clients that obtaining the licensing would only call them to the attention of apparently otherwise unconcerned regulators. Others were reluctant to provide any kind of a clear opinion at all. And a few vigorously recommended full compliance. Everyone seemed to agree, though, that M&A transactions were not what the law was originally designed to protect the public from, insofar as the parties to these deals were not the “public,” in the sense that buyers of businesses are either other business or super-sophisticated financial investors.

- Do not mix any other activities (consulting, valuation service, and so forth) of the firm with the M&A activity of the broker dealer. Again, this will make record keeping, auditing, and minimum capital compliance much easier.
- Do not try to distinguish between asset and stock deals. Just run them all through the broker dealer. Even an asset deal may possibly take the form of a stock deal. And as such, it was probably offered in a manner that may have come under the provenance of the Uniform Securities Act at a state level.

## Engagement Intake Management

I would like to finish up this section by sharing a couple of hard-won insights that hopefully may save the neophyte investment bank or banker from some of my own early mistakes.

### **Taking on Clients without Retainers or Commitment Fees**

My advice? Never do this. Again, watch my lips: *Never do this*. I have already talked about the new banker's excitement in getting a deal, any kind of a deal. The deal (combined with the banker's inexperience) tends to blind him or her about the realities and vicissitudes of actually completing a transaction. One of these vicissitudes is client commitment, which I discuss elsewhere in this book. A client who has no skin in the game is not a client. He or she has not made a commitment to actually doing a deal. There are plenty of curious clients out there, willing to have you take on loads of work just to find out what their business might be worth.

One way to weed these out is require a retainer or commitment fee up front, in an amount significant enough to demonstrate the client's seriousness. When this advice was first given to me, I relegated it the old psychiatrists' mantra about how a patient who did not pay his fees on time was not committed to the process and therefore would not be susceptible to therapy. I initially thought that this was just so much malarkey to justify the psychiatrist getting his fees paid or the banker collecting some money. I soon learned that the advice reflects a real and deadly truth, which is ignored to the banker's detriment.

I would consider budgeting a retainer over several months (and have done so), occasionally reducing one a bit in cases where I really believed the issue was not one of lack of commitment, but I do not trust my own judgment enough to suspend the retainer altogether. In fact, I trust my judgment enough to be rigidly resistant to suspending retainers.

## **Vetting New Deals (especially Capital Raising Deals)**

All of us have our blind side when it comes to taking on transactions, even when the retainer is not an issue. The blind side can work either way, too. It can cause inappropriate deal rejection, as well as acceptance. Another way to sponsor the all-important issue of teamwork in boutique investment banks is to insist that all potential new engagements be vetted by a committee. The sense of teamwork, the minimization of acceptance and rejection error, and the discovery of hidden strengths or contacts within other bankers relevant to the vetted deal can be very productive for a firm.

The vetting process can be every educational, as well, from the point of view of less experienced bankers. The committee process tempers the zeal of less-experienced bankers, who are prone to making errors in the direction of accepting engagements that cannot be executed, especially in private equity and other capital raises. The process also tends to make the less experienced bankers more aware of the areas of experience possessed by their fellow bankers on the committee, who might actually help a deal get done.

There is more to a good capital-raising opportunity than simply the latest and greatest idea, even if it is the latest and greatest. Timing, management, capital markets appetites, and many other issues may have a great bearing on the likelihood of success. In my view, the tender balance between a great idea or company, and a company that capital can actually be raised for, is not learned easily or quickly.

First of all I choose the great roles, and if none of these come, I choose the mediocre ones, and they don't come I choose the ones that pay the rent.

Michael Caine

## **Climbing the Deal Size Ladder**

Yes, we all want bigger deals. We know they are easier to do, actually take less time, and frankly are more fun and prestigious. But I strongly disagree, and have throughout my professional career, with the advice that says if you want bigger deals (clients) you should stay away from small ones. Do a good job with the small ones and your referrals will multiply. Both in investment banking and in public accounting, some of the largest clients I have ever represented were referred by some of the smallest clients I ever had. The only exception I make to this is to strongly recommend staying away from Mom-and-Pop business brokerage deals—not because they are small, but because they are a different business altogether, involving (as I have pointed out elsewhere) different techniques. Here, it is frankly easy to get pigeonholed as a business broker. Avoid that niche like the plague.

# Success in Life and M&A

It may seem, from the sports (golf) analogies I have suggested in this book, that I may be some kind of fanatical sports fan. Actually, I am not. I rarely watch sports, with the exception of a few major golf tournaments. Fortunately I am married to a woman who more or less is a rabid sports fan, across the board. You name it, she watches it: football, the Kentucky Derby, golf, basketball. Her enthusiasm and total absorption when she is watching the latest sporting event on television make me grin, at least internally. She plays not a single sport, unless you consider gardening a sport—

While I feel that the cliché that sports including golf are a metaphor for life is often belied by the all too corny and trite comments made by athletes and coaches in their pre-and post-game interviews (they must give these guys all the same script), I also have had the pleasure to live during an era when one single athlete so dominates his sport that I do take notice of what he says . . . but mostly of what he does.

His name? Tiger Woods.

Of course I do not know this guy, and if I did, I might be disappointed in the actual person . . . or not. Who knows? But I have listened to his answers to the inane questions of sports commentators following his latest victory over men who themselves are elite athletes. The answers seem to be summarized in a few central ideas that all of us would do well to note.<sup>11</sup> And I can guarantee you these apply to the world of M&A investment banking. I want you to understand that when I talk about winning in this context, I am not talking about defeating someone. Winning is a very personal and private thing and has nothing to do with defeating the other side:

- *Forget about numerous goals.* Stay with the big picture. One goal is enough, and that is to just get better every day and success will result (i.e., do not spread yourself thin).
- *Losing comes with winning.* Get over it. Life continues, and there is always another challenge and another opportunity. Concentrate on that (i.e., do not get discouraged).
- *If you are going to play, play to win.* Learn to grind on every shot, every deal, every client relationship (i.e., pay attention to detail).
- *Never, ever, give a half-hearted effort.* Stay in the moment for yourself and your clients (i.e., if you are going to do this, do it all the way).

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<sup>11</sup> Most of these ideas, or their essence, are taken from an article or articles from a little-known golf writer, Wayne DeFrancesco, who himself stands well above the golf writing crowd in terms of intelligent commentary on this elusive sport and, whether Wayne realizes it or not (I suspect he does), on life.

# The \$10 Trillion Opportunity

My enjoyment of this profession has been immense, and occasionally immensely financially rewarding (in between periods of wondering where the hell the next deal is going to come from, of course). It has had me on more airplanes than I care to mention, traveling to exotic places like West Africa and a lot of less exotic places like Omaha, Nebraska. I have been involved in more industries than I can remember, I have met more “characters” than in a Monty Python episode, and, at times, I have been called on to find creative juices that I did not know I had. I have had clients to whom I became so close they remained lifelong friends ,as well as parties on the other side of a transaction who swore they would never talk to me again (or worse)—but many of them I worked with later, on other deals and we became real friends.

If you have to ask: Yes, I would do it all over again (I am still doing it, for that matter). If you have a wandering and wondering mind, a love of people, a relish for excitement and adrenaline rushes—in other words, if you are a “deal junkie,” go for it.

Furthermore, in what has been termed the \$10-trillion opportunity (somewhat of an exaggeration from our own research, but still in the trillions when it applies to Middle Market M&A), I see only good things and very hot markets (with some of the usual lulls, of course) in the future of the M&A intermediary profession. Without overly repeating an introductory chapter, a vast number (about 800,000) of Middle Market businesses will change hands over the next ten years as a result of baby boomer retirements and technology advances, not to mention the cross-border movement to a one-world business economy. About 2/3rds of these will be sold with an estimated market value of \$3.3 trillion. Almost 3.3 trillion anything is a staggering quantity to grasp. For instance, 3.3 trillion hours ago was 150 million years *before* the first dinosaur existed. A 3.3 trillion gallon wave would form a puddle 8 inches deep the size of Lake Michigan. How about 3.3 trillion equals the number of miles America drives each year (200 billion gallons of gas @ 17 mpg), the total barrels of extractable oil shale reserves, and the number of miles to the furthest star (Andromeda Galaxy) that can be seen by the naked eye?

## Chapter Highlights

- Key characteristics of a successful investment banker are an enjoyment of people, a love of variety, and an ability to take huge risks.
- Most Middle Market investment banks are modeled on an “eat what you kill” (EWYK) basis and therefore difficult for younger people to enter, other than through an analyst position.

- Entry through a consulting or other professional practice can be done (see Exhibit 30.6), but barriers to this approach include insufficient expertise and experience, lack of licensing, cultural and economic clashes between partners, and lack of credibility.
- One half of a banker's or bank's time is spent on marketing tasks:
  - Mass marketing can be accomplished through seminars newsletters, databases, etc.
  - Narrow marketing through highly selective networking is very important to developing new business.
  - Impressionistically, it takes an estimated 17,000 to 20,000 points of contact to land an engagement.
  - A banker is looking for, and trying to be in front of, *selling* clients, not buyers, when he is marketing.
  - Being in the business for a long time, with a loyal referral base coming from quality management of previous deals, is the best way to sustain a practice.
- Specialization is a great entry point to banking, but do not place all your eggs in one industry basket.
- The New York style of banking, while it can be effective, is not seen particularly frequently in the Middle Market.
- Consider establishing an exit strategy subpractice to develop good immediate income and long-term deal flow.
- FINRA, the SEC, and collateral legal concerns make it practically mandatory for a bank with any growth ambition to obtain the proper securities licenses and entities.
- There is a \$10-trillion opportunity (more or less) out there.