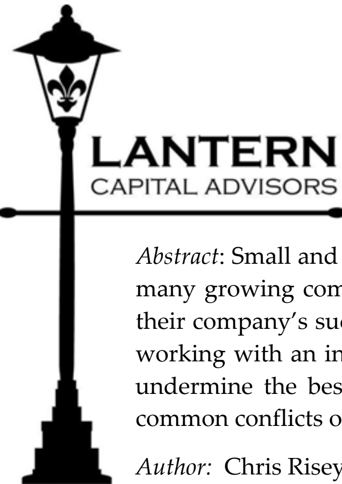

WHITE PAPER:
Investment Banking Fees Examined

Abstract: Small and mid-sized companies looking to raise capital intuitively turn to investment banks for help. In fact, many growing companies view working with a well known investment bank as an attractive milestone that signals their company's success and future potential. However, CFOs should be aware of the significant fees involved when working with an investment banker, and more importantly, conflicts of interest with investment banking which can undermine the best interests of the company. This white paper describes investment banking services and fees, common conflicts of interests, and suggests an alternative approach that has worked well in other professions.

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Typical Investment Banking Approach and Fees

Growing businesses routinely have a compelling need for additional capital. These needs may arise because the business is growing faster than the company's internal resources or bank line of credit can support, or an attractive acquisition opportunity has appeared, or a partner or owner is willing to be bought out (typically referred to as a management buyout or leveraged buyout). Companies realizing that they know little about the financing process and wanting to protect the value they have already created, routinely seek help from an outside financial advisor. In many cases, companies will initially contact an investment banker or investment bank to help them understand their financing alternatives and find the capital necessary to realize their objectives. Some companies may even view signing up with a well known investment bank as a significant milestone event that signals the success and future potential of their company.

For small to mid-sized companies with valuations below $100 million, investment banks will typically charge fees that are comprised of three components: an upfront or monthly retainer, a cash fee paid upon closing of financing, and additional equity compensation. Quite often the retainer, whether paid upfront or over time, is $25,000 or more. This fee is usually non-refundable, netted against future fees, and may or may not cover out of pocket expenses. The closing fee (also called a "success fee") is usually an additional variable fee that ranges from 2% and 10% of the *total capital* raised. In general, the smaller the financing, the higher the variable percentage fee is applied to the capital raised. In addition to cash fees at closing, investment banks often seek equity compensation at closing. Most equity compensation is paid in the form of warrants, providing the investment bank the option to buy the company's stock in the future, allowing them to realize even more compensation should the company have a future liquidity event, such as a sale or IPO. Similar to the closing fee, warrants can vary substantially, but the initial value of warrants could equal *additional* compensation of 5% to 10% of the capital raise.

As the above description suggests, investment banking fees can add up quickly. Many investment banks will set minimum cash fees as high as $500,000 or sometimes more. Investment banks rationalize their fees based on the value the financing provides the company and the understanding that the investment bank is only paid the backend fees contingent on a completed transaction. While this approach is often necessary for early stage companies with little cash and an uncertain future, investment banks apply this same fee structure to profitable, growing businesses. Most investment banks prefer to work with profitable growing businesses, because the challenge in obtaining financing is not nearly as high as the compensation would imply.

Common Conflicts of Interest

Beyond the fees, there are other industry standard practices which can create hidden conflicts of interest between the investment bank and the company they represent. Conflicts of interest are not new to investment banking, and they have been indentified, addressed, and legislated in many areas such as IPO pricing practices, insider trading, and research opinions. Two conflicts most common to capital raising include:

Investment banks earn higher fees raising equity – It's not uncommon for investment banks to quote two different fee percentages for each financing engagement. One percentage fee for equity and one percentage fee for debt. Typically firms are paid significantly more to raise equity than debt (i.e. 2-3% for debt vs. 5-10% for equity). The rationale is that raising equity capital is more difficult because equity investors are more selective.

One conflict that may arise is that many good growing companies qualify for debt only financing or a combination of debt and equity. Investment bankers often have a strong economic incentive to lead the clients to equity over debt. However, most thriving companies prefer to maximize debt first, because debt minimizes the company's equity dilution and can be paid down or refinanced in the future.

Equity compensation – As mentioned earlier, investment banks often take additional equity compensation for raising capital. The logic is that investment banks earn additional future compensation as the company grows in size and value. The conflict of interest is that the valuation of the company is based on the value of the company *at the time* of the investment. This means the investment bank has more upside the *lower* the company's valuation at the time of the investment. This is the exact opposite of the company's best interest. Business owners want capital at a *high* valuation because it minimizes equity dilution, whereas the investment bank profits *more* the *lower* the valuation.

TABLE 1: ILLUSTRATION OF INVESTMENT BANKING FEE RANGES BY TYPE OF FINANCING

Illustration

Here's a simple example to illustrate the impact of these conflicts. Assume a fast growing company raises $10 million of capital and grows its company value from $20 million to $125 million in five years (roughly approx. 35% compounded growth rate.) Depending on whether the capital was raised in the form of equity or debt (most likely subordinated debt), investment banking fees could range from $300,000 to $2 million for the *same transaction*. Even more important, selecting equity dilutes the ownership for the existing company shareholders by an *additional 25%* over a comparable debt financing.

	Investment Banking Fees			Financing				Totals
	Closing Fees	Warrants[1]	Total Fees (A)	Investment Amount	Cost of Financing (B)	Investment + Financing Costs	Investor Ownership[2]	Fees + Finance Cost (A+B)
Equity	$ 500,000	$ 1,583,333	$ 2,083,333	$ 10,000,000	$31,666,667	$ 41,666,667	33.3%	$ 33,750,000
Debt	300,000	-	300,000	10,000,000	12,500,000	22,500,000	7.5%	12,800,000
Difference	$ 200,000	$ 1,583,333	$ 1,783,333	$ -	$19,166,667	$ 19,166,667	25.8%	$ 20,950,000

Assumptions

Investment Banking Fee As Percentage of Debt	3%	Target Rate of Return for Equity	33.0%
Investment Banking Fee As Percentage of Equity	5%	Target Rate of Return for Debt	20.0%
Warrant Comp as % of "Post Money" Valuation	5%		

FOOTNOTES:

1. Warrants paid to the investment bank are calculated as follows: $10 Million (Capital Raise) X 5% (Fee Percentage) = $500,000 (Implied Value) / $30 Million (Post Money Valuation) = 1.67% (Earned Warrants) X $125 Million (Future Company Value) = $2.08M (Value of Warrant) - $500,000 (cost of warrant or strike price) = $1.58 million. Warrants were not assumed as part of the compensation for the debt financing. Determining the warrant value for debt is often more difficult because a definitive company valuation does not need to be determined in an all debt capital raise. However, determining the company's value is required in an equity raise in order to determine the investor's ownership interest in the company.
2. Investor ownership for equity of 33% is calculated assuming a $10 million investment amount and $30 million company valuation post investment. The equity dilution of 7.5% for debt assumes the (subordinated) debt provider charges an interest rate of 10% per year, the principal is paid in full upon maturity in five years, and a warrant or equity consideration of 7.5% is received in order to give the debt provider a target annual return of 20%, given the company's future valuation of $125 million. Warrants are typically redeemed by the investor after maturity of the note or upon a future liquidity event such as the sale of the company. Warrants can also be paid off with future cash flows or a refinancing. This eliminates any equity dilution.

Other Conflicts

In addition to the conflicts identified above, there are other investment banking engagement practices which can work against the best interests of a company they represent. They include:

Predetermined term sheets – Investment banks often get companies to agree to financing terms *prior* to soliciting capital. The company's expectations are then captured in a "term sheet" that is included in the business plan and sent to financial institutions. Investment bankers reason to clients that investors don't want to waste their time on a company with unrealistic investment expectations. However, this practice can greatly reduce the valuation ranges and terms for financing. This is particularly true for high growth companies, where investors can have a wide range of opinions on a company's valuation. It's not uncommon for a company's valuation to differ by as much as *50%* from one institution to another. This range in valuation then leads to significant differences in the amount of equity the company has to sell in order to raise the same amount of capital. By allowing investors to determine the valuation and terms of financing of the company during the process, the value of the company is maximized, however it works against an investment bank that wants to get a deal done quickly and is getting ownership at the valuation of the investment.

> *"Taking finders' fees creates obvious conflicts and potentially adverse selection or introduction"*

Long exclusivity period – Transactions can take as long as six months to close, but investment banks routinely require an exclusivity period of one to two years. This means the investment bank will be compensated on the same terms if *any* capital is raised during that exclusivity period. The rationale is that as brokers, the investment bank has committed significant time and resources to the engagement outcome and they don't want a company to circumvent their process after committing those resources or have the company later change their mind. The problem is that if an investment bank cannot deliver attractive financing, the exclusivity period serves as a road block to considering other alternatives with other sources and, and ensures the investment bank gets paid regardless of performance. For a rapidly growing company, two years can be a lifetime. As a result, some companies have to put their financing efforts on hold, simply pay the fee, or look to settle on a lower fee. Often, the last alternative is already spelled out in the agreement as a break-up fee. This fee is owed should the company decide to terminate the agreement. The fee is often $50,000 or more and is not netted against the retainer.

Finder's fees – In addition to fees paid by the client, investment banks and brokers may also take finder's fees from the investing institution. It's not uncommon for the finder's fees to be $50,000 to $100,000 or more, and the finder's fee is paid to the firm or person *making* the introduction. Because investment banks do this type of work all the time, they already know which institutions or investors pay the highest fees. Taking finders' fees creates *obvious* conflicts and potentially adverse selection or introduction, since those institutions paying the highest fees are likely those that have the greatest difficulty attracting good investment opportunities.

Co-investments – Many investment banks will market that they will invest their own capital in a company. This is intended to demonstrate the investment bank's commitment to their client and financial strength. However, investment banks rarely commit any capital unless all the other capital is raised from other sources. Also, the amount of the investment bank's contribution is usually small relative to the size of the financing need. Also, if it's done at the same terms as the total financing, it creates another conflict of interest because there is no incentive for the investment bank to maximize the valuation for the company.

Highlighting these conflicts clearly illustrates why investment banks constantly portray that they have the client's best interests in mind, when their fees, bonuses, and future returns suggest otherwise.

It's important to also note that investment banking fees are *in addition* to other fees the company can expect to pay out at closing such as out of pocket expenses, legal fees, due diligence, accounting costs, and origination fees (or points). If a company is rolling those costs, including the investment banking fees, into the closing, the company is being financed at the *new* cost of capital, which further compounds the cost.

A Professional Services Approach

Companies have simply been conditioned to assume that investment banking and its high cost approach is the only option. Given these challenges and conflicts, an alternative approach and solution is available to profitable, growing companies that is not widely used, but highly valuable, equally successful, and cost effective.

Operating like an accounting firm, consulting firm, or law firm, a corporate financial advisor charges the company on an hourly, consulting fee for their firm's resources to develop the financing plan, write the business plan, access (the same) financial institutions, distribute and market the business plan, set up meetings with financial institutions, negotiate proposals, and assist with the closing process.

> *"The industry has simply been conditioned to believe that Investment banking and its high cost approach is the only option."*

Individuals and firms that serve as corporate finance consultants do not accept referral fees, equity compensation, warrants, or charge rates dependent on the amount or type of capital raised. Corporate financial consulting firms charge their clients an hourly rate, and are paid *throughout* the process, with no additional costs or fees being charged, incurred, or paid by third parties, outside of the process. Although fees are not contingent on the financing closing, companies can expect that total project fees through a successful closing are similar to the retainer and 'break up' fee charged by an investment bank.

A typical financing project, regardless of whether completed by an investment bank or an experienced financial consulting firm, requires between 150 and 300 professional hours to complete. Using hourly bill rates that are comparable to a consulting, accounting, or law firm, *the total cost of the same service with a positive result is a fraction of what investment bankers charge*. More important than the fees involved, clients can also get independent advice and peace of mind that the advice is in *their* best interest, and not conditional or weighted towards the backend financial impact for the advisor. Just like any other advisory profession, those with relevant corporate financial advisory experience, competency, and contacts can consistently deliver value and results for clients, without the high fees or conflicts of interest that could arise while working with an investment bank.

About the Author: Chris Risey

Chris Risey is the founder and President of Lantern Capital Advisors, an Atlanta-based corporate financial consulting firm specializing in helping successful entrepreneurial companies plan for and achieve financing for growth, acquisitions, and buyouts from a variety of institutions, including banks, specialty and mezzanine lenders, venture capital firms, and underwriters. Since its formation, Lantern Capital Advisors has helped clients successfully develop strategies and access capital in order to fund their company in a way that best suits their unique needs and growth potential.

Prior to founding Lantern Capital Advisors, Mr. Risey served as a Managing Director for a niche consulting firm in Tampa, Florida, that provided corporate financial consulting and helped companies raise capital. After nine years, Mr. Risey left to launch Lantern Capital Advisors in order to provide cost effective services and high client satisfaction. Chris started his professional career as a CPA in the audit and advisory services group for Arthur Andersen in New Orleans, Louisiana.

Active within the business and civic community, Mr. Risey has served for many years in a variety of leadership roles within Rotary International, Financial Executives International, and The Association for Corporate Growth. Mr. Risey is also a frequent and vibrant speaker for financial executives and entrepreneurs throughout the country interested in learning more about today's financing and planning strategies that are necessary in order to create significant value for a variety of companies, as well as the current impact the financial markets are having on today's successful companies, and their ability to access financing.

Mr. Risey is a magna cum laude, full scholarship graduate of the University of South Florida, with a degree in Finance, and was twice named Academic All-American (Men's Basketball). Mr. Risey is a former Rotary International Ambassadorial Scholar, and attended the Australian Graduate School of Management at the University of New South Wales in Sydney, Australia on a full scholarship.

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About Lantern Capital Advisors

Lantern Capital Advisors is a corporate financial consulting firm that serves as a strategic corporate financial advisor to growing private companies. Our consulting services deliver substantial value for our clients by assisting them with strategy assessment, business planning, and the evaluation and selection of capital sources and liquidity alternatives.

Our clients are fast growing business that are being held back because of limited capital. By engaging our services, Lantern Capital Advisors helps companies determine their capital needs based on the funding requirements of their own growth plan.

We secure financing for our clients from a broad range of private and public financial institutions. We help companies find and negotiate business financing that minimizes dilution and personal financial liability to the company owners. We also assist our clients in buying out company shareholders in order to further increase the future value of the business.

As independent corporate financial advisors, Lantern specializes in finding creative corporate financing solutions that maximizes shareholder value by minimizing ownership (equity) dilution and personal financial risk.

Many clients have limited prior experience in the capital markets and want to gain the benefit of an experienced advisor to source funding alternatives and give advice that is in their best interest. Lantern Capital Advisors hourly based, consultative approach uniquely positions us to do just that. Our professionals have been engaged in a broad array of large and small assignments across various industries across the United States. Common client engagements and activities include one or more of the following:

- Evaluate growth and valuation alternatives
- Secure capital for growth or liquidity
- Coordinate mergers/acquisitions
- Coordinate management buyouts
- Prepare quality business plans
- Replace current lenders or investors
- Remove personal debt guarantees
- Solicit underwriters for securities offerings