
# INVESTMENT BANKING EXPLAINED

## [ AN INSIDER'S GUIDE TO THE INDUSTRY ]

SECOND EDITION

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# Strategies in Relationship Management

Goldman Sachs is credited with having invented a new function in investment banking: managing client relationships. "Modeling itself on a manufacturing, rather than a service, industry, Goldman Sachs would build a sale department that would do nothing but sell. Taking a radically different approach from that of its competitors, the member of Investment Banking Services (IBS) would fan out and cultivate business, then turn over its execution to specialists."[1]

In today's IBs, these people have different names, but they all have the same goal. The purpose of *relationship managers* (RMs)—or *client executives* or *senior bankers* or simply *bankers*—is to build and manage client relationships. RMs aspire to be the leading trusted advisor to their clients, which include corporations, financial institutions, and public authorities.

But the role of client relationships had changed in the five to ten years before the 2007–8 crisis. It became a product push rather than best-in-class advice—even at Goldman Sachs. On April 11, 2016, the Justice Department announced

> a $5.06 billion settlement with Goldman Sachs related to Goldman's conduct in the packaging, securitization, marketing, sale and issuance of residential mortgage-backed securities (RMBS) between 2005 and 2007. . . . "This resolution holds Goldman Sachs accountable for its serious misconduct in falsely assuring investors that securities it sold were backed by sound

> mortgages, when it knew that they were full of mortgages that were likely to fail," said Acting Associate Attorney General Stuart F. Delery.[2]

After the crisis, IBs have reoriented their business models toward the customer. Relationship management is the tool that permits banks to reestablish trust with their clients.

## What Is the Role of a Relationship Manager in an IB?

RMs are not aligned with one specific product, but they provide best-in-class advice and execution excellence on the most complex transactions across products. This means offering the right solution at the right time and not being skewed to any product offering. In other words, it's about putting the clients' needs first.

A good RM strives to be a trusted advisor to her client. She understands her client's needs and provides innovative investment and financing solutions to help her clients meet their financial goals. She works with specialists and groups from around the bank to help them make the right decisions. She is a strategic thinker with an analytical mind and strong problem-solving skills. She identifies opportunities and generates new business for the bank.

Contrary to this rose-colored-glasses view, a career guide to investment banking gives a rather cynical definition of the job of RMs: "The MDs' [managing directors'] most important task includes schmoozing in the industry, finding potential deals, and pitching them with confidence and poise. Public speaking skills, industry awareness, demonstrated experience and an ability to sell combine to create the best bankers. Importantly, however, MDs must still be able to grasp the numbers side of the business and be able to explain them to clients."[3] Frankly, this comment is demeaning. The RM may be the most important asset of an IB; even if her only asset is her reputation and the trust of her clients, the relationship manager is essential for the firm's success.

As the former chairman and CEO of Goldman Sachs, Henry Paulson, said, "Good firms worry about competition. Great firms worry about their clients."[4]

## Four Keys to Successful Relationship Management

Four elements form the core of relationship management:

1. **Client segmentation.** The essence of segmentation is not trying to be all things to all people but to meet the specific needs of specific clients. Best-practice RMs have a deep understanding of customers' needs. An RM manages and develops the overall relationship with the client. A good RM can identify a handful of services the bank can do well and focus on which client profile fits best with the bank's line of products. He seeks to match the strengths of his bank with his most potentially profitable customers. These customers should command the lion's share of the firm's marketing efforts and resources.
2. **Culture and operational model**. The RM is "the bank" for the client, and he is "the client" for the bank. The IB's organizational chart is only a framework. Leading IBs organize their resources to deliver the right solution to the right customer at the right time. What matters is how investment bankers work together to deliver "one bank" to clients with total communication and collaboration across businesses and genuine teamwork. Best-practice RMs successfully overcome turf issues and facilitate continual communication among product specialists and RMs to better serve the customer. They break down silos and create processes that bring people together. Everyone shares the same information, sees what has been done, and knows what to do.
3. **"Plan your play and play your plan.**" Best-practice RMs develop a clear and simple plan and stay the course. They define the commercial strategy with the client and are accountable for client profitability, risk, and allocation of capital. They set up annual account plans with a vision of two to four years and define with the business lines the marketing plan and joint commercial objectives for each client. They conduct an in-depth annual relationship review with each client led at the client's highest level of management, often with an executive sponsor of the bank. Another way for the bank to assess performance is through the Greenwich Associates' surveys, which can be complemented by an executive sponsor's visit to the management of the client to assess the client's satisfaction with IB issues.

4. **Information structure and IT systems.** In a Tier One global IB (see Chapter 3) at scale across products and services, one corporate client can be buying dozens of different services from that bank. In Tier Three IBs, RMs face the challenge of managing an increasing number of customers. Banks must rely on comprehensive and integrated information systems to provide a more holistic view of customers and link that knowledge to the RM. Customer relationship management (CRM) systems are used to extract historical data on past transactions and a profile of a customer's profitability. This profile feeds into a uniform planning process based in part on the CRM system that can adjust the process automatically. Banks have become more scientific about how they evaluate their performance with their clients.

## Types of Relationship Managers

There are four types of RMs:

- Super banker
- Coordinator of product specialists
- Tandem RMs (a generalist and a product specialist)
- Functional RM (a product specialist who works as an RM for middle-market clients)

The super banker is the cornerstone of the bank's relationship with its corporate clients. Her job is to know both the business of the client and its leadership well enough to bring in specialists to meet any of the company's financial needs. This model prevails for the Tier One global IB. For money center banks, which offer specialized services, the RM is a coordinator of product specialists. He pulls together the total marketing effort, but product experts market directly to customers. The tandem system has two separate RMs, one for commercial banking and one for IB activities, who oversee product specialists. In the functional model, different specialists are responsible for the sale of their own products, but there is no central customer contact point. Banks have found that this is not an ideal way to develop customer relationships.

## How Do You Reestablish Trust with Clients?

In Chapter 5, we mentioned the surveys conducted by *The Economist* to measure its readers' attitudes and perceptions about the investment banking industry. One of the questions in the 2014 survey was, "Which factors best motivate readers when selecting an investment banking partner?" Readers saw trust execution and expertise as key to decision making. Of those who had used an IB in the preceding three years, 82 percent considered that "trusted and objective advice" is very important, 71 percent mentioned "execution capabilities," and 69 percent said "expertise/specific skills."

Paul Myners, a British businessman and politician, said long ago that "the selection of an investment bank is, at its heart, about people. And here, personal relationships are hugely important because, in the end, the decision should come down to trust, based on prior experience or recommendation. Do you trust the banker? People tend to trust individuals, not organizations."[5]

Follow these four steps to become a trusted advisor:

1. **Focus on the client.** Continually have the client's best interests in mind—well beyond the existing project. At root, a good RM really cares about the client, not just the problem. He views issues through the client's perspective. He thinks strategically to understand the client's problems and devises a new solution for that situation. A good RM takes a long-term perspective. He is not a transaction-oriented cog but a relationship-driven person.
2. **Maximize truth.** From day one, when an RM starts talking to a client, she should try to develop trust. In Chinese, the word *trust* is written (in pinyin) as *xin ren*. The first part of the ideogram means "credit or credibility." The second appears in such words as *task* and *appointment* and suggests reliability. An RM gains credibility with content expertise and accuracy. A good RM is intellectually honest and expertly examines various sides of an issue, making sure that everything has been covered. She spends an enormous amount of time trying to figure out where she might be wrong. One banker stated: "If it feels right, don't worry so much about the prevailing wisdom." She remains levelheaded, honest, and in control. The real

measure of a good RM's talent is in her sustainability through difficult periods.

3. **Be reliable.** Reliability stems from aligning promises with actions. Integrity derives from the Latin *integrare*, "to make whole." A person of integrity is a person whose conduct and principles operate in happy harmony. Integrity is crucial because people have a need to reconcile their conduct and their principles, and we do this either by acting in accordance with our principles or by abandoning principles that conflict with our wrong actions. David Luban at the Georgetown University Law Center puts it this way:

   > The high road, if you choose to take it, requires you to conform your conduct to your principles. That occasionally demands agonizing sacrificial choices: to resign from your job, for example, when continuing to do what your client asks requires you to cheat and shred and cover up. . . . The low road is so much simpler—that, of course, is what makes it the low road. If your conduct conflicts with your principles, modify your principles. This is the path of least resistance, so much so that apparently, we follow it unconsciously all the time.[6]

   It is important to take a stand, forge your own path, and be unafraid to share opinions. Take the high road.

4. **Beware of your ego.** Ego is the cardinal sin of relationship management. There is no greater source of distrust than advisors who appear to be more interested in themselves than in trying to be of service to the client. Charles H. Green, an advisor on trust-based relationships, says: "Frequently professionals have only the best motives, and are unselfish—but they are also self-conscious and self-absorbed. They worry about their credentials, about how they are being perceived, about how smart they seem, and about whether they'll get the job. To that extent, they are not focused on the client in front of them—and to that extent they won't be trusted."[7]

## CASE STUDY

# The Year When Merrill Lynch France Displaced Goldman Sachs to Advise the Largest M&A in the World

In the early 1990s, the French company Société Nationale Elf Aquitaine (Elf) was one of the world's top 10 oil companies, the fourth-largest producer of natural gas in Europe, and the continent's fifth-largest refiner and marketer. The company had a strong presence in Africa as well. Through its subsidiary Elf Atochem, it was the world's thirteenth-largest chemical maker, while through its 15 percent equity interest in Sanofi, a midsize drug company, it was the eighteenth-largest pharmaceutical firm in the world. Elf was France's largest industrial corporation. The French government was the main shareholder (with 64 percent), although the stock Elf Aquitaine was quoted on the stock exchange. Its American depositary receipts (ADRs)[8] were quoted on the NYSE. Goldman Sachs was then its preferred foreign investment bank; however, Merrill Lynch's oil analyst, Sue Graham, was the darling of Elf's people.

## How Did Merrill Get Its Foot in the Door?

Merrill Lynch had to convince the finance people at Elf that Merrill was worth talking to on financial issues. This is the *rule of engagement*. You need to earn the right to engage in a mutual exploration of ideas. Merrill began with an analysis of the client's problems, then it looked at how the expertise of the bank could be helpful, and finally, it pondered how it could create enough trust to displace Goldman Sachs.

First, Merrill Lynch tried to clarify the many issues involved in the client's problems. What were Elf's needs? The company faced very high capital expenditures and could not raise equity capital because the French government did not want its equity ownership to be diluted. Elf had used debt issues extensively in the past to finance its investment. The firm enjoyed an AA credit rating, but that rating was somewhat at risk. In order to improve its rating, Merrill Lynch recommended that the company increase the average maturity of the debt (the time at which the debt is due) because ratings agencies pay a lot of attention not only to the size of the debt but also to when it is due.

So Merrill Lynch offered a solution to the maturity problem. American investors were used to investing in corporate bonds, and a 10-year bond was not a problem for them. What could be a problem in this case was that many small financial institutions could not invest in a firm that was not listed in the United States. But Elf had listed its ADRs on the NYSE four months before, with Goldman Sachs as the lead underwriter.

## How Does a Banker Help the Client?

A good banker first tries to understand how to combine the bank's product capability with the customer's needs and then identifies the strengths the bank has that can be used to develop a solution. In the case of Merrill Lynch, it had an intimate knowledge of the debt markets in the United States and a huge network of retail investors looking for financial assets that offered a decent return for little risk. In addition, Merrill Lynch had a good angle: it could help with the trading of the bonds in the secondary market.

As I will explain in Chapter 12, a *Yankee bond* is a bond denominated in US dollars and issued in the United States by a foreign company. Once issued, these debt securities are traded in the secondary market. However, most Yankees bonds, because they come from non-US firms, are not easily traded in the marketplace. Investors often find that they must hold onto their bonds rather than sell them. This leads to low liquidity (the ability to trade bonds at stable prices) and higher transaction costs. There is a market in the bonds only in the first few days after issuance, as part of the "allocation process." After this period, liquidity is typically low, reflected by the small number of buyers and sellers and low trading volume. The lack of liquidity is evidenced by a sizable difference between bid and asks prices (generally called the *bid-ask spread*). The two-way pricing is provided by the lead underwriters of the issue and very few other brokers, if any. Merrill Lynch could solve this problem by committing to provide liquidity through its strong customer base of private investors.

In addition, Elf had used Goldman Sachs for its NYSE listing of ADRs, and it did not want to give the impression that all finance transactions would be given to Goldman. As a result, Merrill Lynch won the lead management of a plain-vanilla US debt issue, a Yankee, in July 1991. The co-lead managers were Goldman Sachs and JPMorgan Chase. The $300 million 10-year debt issue was the French firm's first in the United States.

## A Preferred Solution

A year later, Merrill Lynch convinced Elf to issue auction-market securities. *Auction-market securities* are preference shares issued by a company that have a variable dividend set at a market rate every seven days through an auction between investors. The dividend is reset at a rate that is fixed until the next auction seven days later, when a new yield that reflects market conditions is determined. The security is a form of equity security that has priority over common stock for the payment of dividends. It is a money market instrument (because the interest rate is for seven days) with a longer legal term (because it is a preferred share).

Created in 1984, these securities had previously been referred to as *auction market preferred stock* (AMPS), as well as *variable rate preferred* (VRP), *money market preferred* (MMP), and *periodic auction rate* (PAR) *securities*. Here again, Merrill Lynch had an angle: more than 91 percent of the auction-market securities in which Merrill Lynch participated were rated AAA or AA, the two highest credit ratings. Merrill Lynch's private clients were heavy investors in these securities. With Elf's rating and the priority over common stock afforded by these securities, the issue of auction-market securities by Elf in 1992 received an AA+ rating. Merrill Lynch convinced the company to give it the lead management of the issue. This was a tremendous success in the eyes of Merrill Lynch's private-investor base.

In 1993, Merrill Lynch came up with a new idea and convinced Elf to issue preferred shares in the United States. *Preferred shares* are taxed like equity and paid like bonds. For an issuer, preferred shares rank between debt and equity for rating purposes. They are what we call *mezzanine financing*. The firm first issued $350 million of preferred shares in April 1993 and did a second issue later that year; Merrill Lynch was the sole manager for both. In a few years, Merrill Lynch had displaced Goldman Sachs in the strategic financing decisions of Elf. While the group's debts increased from $7 billion to $10 billion between 1992 and 1995, Merrill Lynch raised a third of the increase!

## Raising the Ante

During the spring of 1993, France elected a new government that planned to privatize state-owned enterprises, among which Elf was the largest. At that time, the only listing procedure in France for new equity was a special kind of Dutch auction (see Chapter 11); the French did not use the book-building method that was prominent in the United States at the time. (*Book building* is a process that allows large stock offerings to be marketed. It is explained in Chapter 10.)

Merrill Lynch started working with lawyers to convince the French government of the merits of the book-building procedure. The work paid off, and all privatizations in France began to use this procedure.

In the summer of 1993, the new government announced the complete privatization of Elf, which opened a competition between IBs to lead the sale of the French government shares in the company. The French administration held its contest to select its advisor for the privatization in October, but Merrill Lynch did not make the group of winners, which, of course, included Goldman Sachs. Since Merrill Lynch had gained Elf's trust in the issuance of debt, it was able to convince Elf to retain it as the company advisor in the privatization. In addition, Merrill Lynch won the lead management of the equity offering in the United States, the goal being to create more liquidity for the ADRs trading on the NYSE. In January 1994, the sale of a 64 percent stake in ELF for FRF385 per share generated FRF14.9 billion ($3 billion) and was one of the biggest privatizations in the world. Merrill Lynch had successfully taken over from Goldman as Elf's financier.

## The Cherry on Top: Texas Gulf

In 1994, Merrill Lynch had the opportunity to displace Goldman Sachs completely in the most coveted role of M&A advisor. Elf wanted to sell its US chemical subsidiary Texas Gulf. The company held a *beauty contest* (a pitch in which all interested IBs compete for business) to select its advisors. It chose three: Merrill Lynch, Goldman Sachs, and Morgan Stanley. The advisors, in turn, proposed a *dual-track procedure*, which is an attempt to sell the company to another firm or to financial investors while preparing as a backup to have the shares listed and offered on the stock exchange. The IPO is a guarantee in case the auction sale does not work. Unfortunately for Merrill Lynch (and Morgan Stanley), the auction sale worked and Goldman Sachs, as the sole advisor to Elf, was the lone executor of the trade sale of Texas Gulf. Merrill Lynch had lost its role as the company's preferred bank. It continued to provide a few services in the following years—for one thing, the bank was able to help structure a project finance solution on an oil field in Qatar—but nothing of substance happened between 1994 and 1999.

## A Total Success

In 1998, the group Albert Frère, the main shareholder of a medium-sized Belgian oil company called Petrofina, wanted to merge that company with a bigger oil company. Albert Frère called on Elf, but Elf turned it down. So the group tried Total, a French oil company half the size of Elf. In December 1998, Total, whose advisors were Credit Suisse First Boston and the French bank Paribas, announced a friendly offer for Petrofina. The market reacted negatively to the announcement, but Merrill Lynch knew the US oil investors very well, and its European oil analyst was still Sue Graham, who had the total trust of European oil investors. Merrill Lynch recognized the value of the merger and proposed to Total and to Petrofina that it explain their strategy to the investors.

The merger between Total and Petrofina would create the biggest industrial group in France. There were large economies of scale to be obtained in oil and gas.[9] Hadn't Exxon merged recently with Mobil? Hadn't British Petroleum acquired Amoco and then Arco? Total hired Merrill Lynch to be the guide. Merrill Lynch organized various investors' meetings for Total in America and Europe. It worked; not only did the stock price recover, but the merger turned out to be a major success.

The transaction was completed on July 2, 1999. That very same day, Merrill Lynch received a call from Total Fina (its new name after the merger with Petrofina). It was not to celebrate the completion of the merger but rather to explain that Total Fina was about to launch a hostile bid for Elf Aquitaine and to check whether Merrill Lynch had a conflict. The answer came back a bit later: no, Merrill Lynch did not have any conflict in advising Total. The following Monday, the board of Total Fina announced its offer for 100 percent of the capital of Elf through an equity swap. Total Fina's advisers were Paribas, CSFB, and Merrill Lynch. Elf responded by launching its own offer for Total Fina, a procedure that is known in the industry as the *Pac-Man defense*.[10] In a Pac-Man defense, the key is to organize a proxy fight and to lobby the institutional investors to convince them to vote for one side rather than the other. Elf was advised by no less than Lazard, Goldman Sachs, Banexi, Morgan Stanley, and, in the end, Crédit Agricole-Indosuez. The presence of large commercial banks indicated that Elf was trying to raise cash through debt in order to buttress its defense. But the strategy did not work. Elf could not muster the majority of votes it needed to increase its capital. Total Fina absorbed Elf to become Total Fina Elf (now Total), thus becoming the fourth-largest oil and gas producer in the world.

This merger was one of the largest in 1999, but it was also the key to the largest merger worldwide in 2004. After its acquisition of Elf, Total Fina Elf had become a shareholder in Sanofi, with 15 percent of the capital, the same percentage as the other main shareholder, the beauty czar L'Oréal. At the time, Sanofi was the second-largest pharmaceutical company in France, behind the Franco-German Aventis.

In 2002, Merrill Lynch was retained by Sanofi to be its strategic advisor for a couple of years. In April 2004, Sanofi launched a $50 billion hostile bid for Aventis with two advisors, Merrill Lynch and BNP Paribas. This merger was completed in the summer of 2004. It was the largest M&A transaction in the world that year.

# About the Author

**Michel Fleuriet** was the Harry W. Reynolds International Adjunct Professor of Finance, Wharton School of Finance at the University of Pennsylvania, and the founder of Université Paris-Dauphine's master's program in investment banking. Prior to his career in academia, Fleuriet served as chairman of HSBC France, chairman and head of investment banking at Merrill Lynch France, and CEO of Chase Manhattan France. He was for many years a professor of finance at HEC and holds a PhD in law from the Université Panthéon-Sorbonne and a PhD in finance from Wharton. His principal experience is in corporate finance and mergers and acquisition.