What is an Investment Banker and How Are Fees Earned?

An investment banker, or professional intermediary, is a firm or individual who represents a seller in the sale or merger of the seller’s business. Investment bankers that work in boutique firms often gained previous work experience in large national or regional firms. Alternatively, some enter the field as a result of personal experience as former business owners that have bought and sold their own businesses and can offer operating experience as an added-value component.

Unlike an investment banker or a professional intermediary, a business broker is an individual who acts as an intermediary between buyers and sellers of “main street” businesses. Generally, business brokers focus on transactions with a price range under $5 million.

While investment bankers are often viewed as operating primarily for large public companies that are worth hundreds of millions, if not billions of dollars, the majority of investment bankers concentrate on private-company transactions in the middle market. Middle market companies range in size from approximately $10 million to $500 million annual sales. The majority of investment bankers and professional intermediaries focus on middle market transactions because more than 80% of businesses above $10 million annual sales fall within the middle market.

Role of the Investment Banker

The investment banker is a critical member of the transaction advisory team whose primary role is to sell the company and meet the seller’s stated objectives, while maintaining strict confidentiality throughout the entire sale process. To successfully meet this role, the investment banker will perform a valuation of the business, develop confidential documents for presentations, market the business to potential buyers, and facilitate the due diligence and closing process. Investment bankers deal with buyers and sellers on a daily basis, develop in-depth relationships with both, and maintain detailed information on the capabilities and interests of each. It is the responsibility of the investment banker to manage and control the entire sale process, increasing the value of the transaction for the seller through simultaneous competitive negotiation with multiple buyers. The investment banker essentially handles the transaction completely, allowing the seller to focus on running their business with minimal distraction.

Valuation

The first step in the transaction begins with a complete and broad valuation of the company. The investment banker will complete preliminary due diligence of the company’s financial information, analyzing financial records from approximately five previous years. Once buyer issues that may be of concern are defined and resolved, and the company’s financial documents are in sufficient order, the investment banker will provide a range of values established by applying multiple comparative valuation techniques.
Although valuation approaches and conclusions may differ among investment bankers, values are generally based on the specific company, industry, management team, hard assets, cash flow, net profits, capital expenses, growth potential, intangible assets, etc. The banker will also perform an analysis of comparable purchase prices paid for similar companies in similar industries. If the seller is content to sell within the range of value, the banker continues to the next step. If the seller is not willing to sell within the provided range of value, the investment banker can assist in identifying steps that can be taken to increase the value of the company.

**Providing Alternatives to Selling**

The investment banker’s primary mandate is to meet the seller’s objectives. When those objectives cannot be met, especially financially, the investment banker is typically willing to assist the seller in finding alternatives to selling. As mentioned in the valuation process, the banker will assist in identifying areas of the business that can be improved to increase the sale value. By focusing on these areas and other value drivers, the business will be in a better position to sell and will receive a higher selling price. At the same time, the investment banker can explain why growth through acquisition may be a better option for the seller, leading to a higher sale price in the future. (See our white paper entitled “Should I Grow Through Acquisition to Increase the Value of My Business?” for more information on pursuing an acquisition growth strategy.)

**Identifying Buyers**

While the seller focuses on operating their business, the investment banker will be performing the essential task of locating and analyzing potential buyers. Through their knowledge of strategic industry buyers, professional contacts, and additional resources, the investment banker then identifies appropriate buyers. The best bankers also think creatively and look elsewhere for less-obvious candidates who may possibly become motivated opportunistic buyer options.

Once a preliminary list of prospective buyers is established, the investment banker determines which ones have the financial qualifications to purchase the company. The list of qualified buyers will then be refined with the seller to avoid any buyers that may pose concerns and add others as appropriate.

**Negotiating Terms**

An investment banker’s role in negotiating financial terms and conditions of the transaction is critical. This is where the banker justly earns their fee. The best investment banker knows how to ideally position the company with each potential buyer to enhance fit and therefore justify higher value. The investment banker must be prepared to stand by or expand value drivers while the buyer’s financial experts will attempt to strike them down. This is where the negotiation skills of the investment banker truly play a role in earning the highest closing price and best-fit terms.

**Facilitating Due Diligence and Closing**

The closing of the transaction is a team effort, where the seller’s transaction attorney and investment banker work together to ensure that communication is maintained with the seller, the buyer and their transaction team, and that all questions are answered in a timely and efficient manner. The investment banker will lead and direct a transaction to a successful closing. This requires coordination between the client’s entire team: attorney, CPA, banker(s), and other advisors. An investment banker will commonly manage and review the activities completed by all parties, conduct reviews with their client, negotiate terms on behalf of their client, provide suggestions, and recommend alternatives. The investment banker also plays a critical role in
facilitating due diligence, ensuring that information flows timely and efficiently between all parties and assisting in resolving any issues that arise during the due diligence process.

Investment Banker Fees

Middle-market investment bankers typically earn a fee or commission based on the closing sale price. This is typically referred to as the “success fee.” It is also common for investment bankers to charge retainer or progress fees as well. The research required for preliminary valuation, buyer due diligence, documentation, and buyer positioning alone is quite costly; however, pre-closing fees are typically credited toward the success fee.

On average, the commission for a business with a $5 million to $10 million value will be approximately five percent of the transaction value. For businesses with values greater than $10 million, the commission will generally decline from five percent as the transaction value increases.

Investment banker fees are not set in stone and may be negotiated. However, it is important to realize that the lowest success fee is not automatically the best fee structure for selling a business. The best fee structure is one that rewards the investment banker for bringing in a higher sale price. The more money brought in for the seller, the more money that the investment banker earns. This gives the investment banker the motivation to expand creative options to potentially negotiate the sale price higher.

Suppose a seller wants to sell his company for $15 million. The best fee structure would increase the investment banker’s commission for each “x” amount in excess of the sale objective. For example, every additional $750,000 over the $15 million target would increase the investment banker’s fee.

Discuss the terms of an engagement letter and fees with your attorney and CPA before selecting an investment banker. They should be included in a conversation with the investment banker, as they can pose questions the seller may not have considered.

Conclusion

Investment bankers play an essential and active role in selling a business. They typically know and understand the seller’s needs as well as the buyer’s needs. Their efforts in negotiation and closing the transaction are vital to the seller receiving the highest sale price. The best investment bankers should possess strong interpersonal and negotiating skills to bring the two parties to reasonable compromise. Privacy of the client and the business transaction should be of paramount importance, and every effort should be made to maintain strict confidentiality. Most importantly, the seller can concentrate on operating their business while the investment banker manages the transaction to a successful closing. The fees earned by investment bankers are worth the value that they add to the business sale, often increasing value to the seller by two to four times the amount of the investment banker’s success fee.

Please contact Aaron, Bell to review your unique circumstances.