



HUGH SANDEMAN

The author is managing director, Langham Capital. He can be reached at hugh.sandeman@langhamcap.com

A furore about fees

International capital markets have so far failed to develop a model for paying a full price for independent advice

It's taken 18 months for the lava from the eruption at Lehman Brothers to wind its way towards the highly combustible issue of investment bankers' fees. Britain's top competition official announced in March that he planned to start an enquiry into fees for mergers and acquisitions and for underwriting. Groups representing major investors are complaining that fees are set by a banking cartel, and that "advisor fees can be enormous...a deadweight cost to shareholders" – all this in an environment where the head of the UK's Financial Services Authority, Lord Turner, is now calling some of the activities of banks "economically useless".

Viewed from India, this debate seems to be happening in another world – a rich world, to be precise. The underwriting fees on one of India's largest IPOs this year, DB Realty, were 2.1 per cent, compared with the 3 per cent or more that the British life insurance company Prudential is paying on its \$20 billion rights issue to acquire AIG's Asian business. The two recent follow-on equity offerings by India's state-controlled NTPC and REC paid bankers just 0.07 per cent (that's seven basis points) on each deal.

The same sense of distance has long been felt between bankers in London and New York, where fee levels have not caught on as an issue of public controversy. In February, the *Financial Times* estimated that fees on IPOs in the US were running at an average of about 6.7 per cent, against 3.2 per cent in Europe and 2.5 per cent in Asia. It costs two to three times as much for a small company in the US to do a private equity placement than it costs in India.

As always, underlying what looks on the surface like a general shift of opinion are some specific causes – in this case, a tactical manoeuvre in the capital markets and an unpopular takeover.

The tactical move in London's capital markets took place last year, when the investment banks that were left standing after the crash were asked to underwrite rescue rights issues for their weaker competitors. US banks, in particular, had long been frustrated by the convention in the London market that rights issues paid fees of 2-2.5 per cent, often less than the fees on simpler follow-on equity offerings. The banks decided to use their

unusually strong bargaining position to push rights issue fees up sharply to 3-4 per cent, where they have stuck.

The unpopular takeover was Kraft's acquisition of Cadbury. Even Cadbury's chairman, who did a good job defending the company, felt queasy about the outcome, musing that company directors should find a way to be "stewards rather than auctioneers". But, as it often happens in the aftermath of disturbing events in financial markets, even people and institutions that accept some need for change have struggled in vain to find any practical reforms that they can reconcile with the conventional view of their established roles. An interesting proposal to restrict voting on takeovers to shareholders who owned their shares before the offer has been brushed aside by institutional investors.

So, by default, the one thing that everybody who worried about Cadbury's loss of independence can now agree on is that fees for the £11.6 billion (\$17.4 billion) Cadbury deal were too big. Kraft paid \$390 million, though much of that was for financing the transaction, where banks bargain for financing fees to make up for tight terms on their loans. Cadbury paid about \$50 million, and, as always, the bankers got paid more for a completed deal than they would have earned if their client had fended off the aggressor. A case of misaligned incentives?

Yes, but it really is up to companies and their shareholders to point incentives for their advisors in the right direction. They could bargain far harder on fees for big transactions, and they could drop the tactic of hiring numerous banks to neutralise competing bids. More important, they could pay much more to their bankers for giving advice on takeovers that do not happen.

The international capital markets, in an exact analogy with markets for retail financial services, have so far failed to develop a model for paying a full price for independent advice. This does not mean that the advice is by definition bad, but it does reduce the incentive for advisors to really work hard to make their clients listen. Viewed from London and New York, one of the markets where clients display the greatest reluctance to pay for such independent advice is India. ♦