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A Historical Word of Caution?

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Let us begin with a premise: Back in the day, looking past the bad and the ugly, the financing field that was spearheaded by Drexel Burnham Lambert contributed positively to the efficiency of capital markets – which in turn improved national wealth in a variety of ways – with the development of an instrument and financing structure that, when properly used, can unlock large amounts of shareholder value. Some may even argue that beyond the financial engineering aspects of high yield debt and leveraged buyouts, these types of transactions also serve to make industry more productive with built-in management disciplines and pressures to perform. When taken to an excess, like most things, high leverage will have negative repercussions, and in fact did. However, and by way of returning to the original premise, it has been shown that the majority of Drexel-sponsored LBOs yielded positive results for both equity and debt holders. Furthermore, it has also been argued that the downfall of this institution came with its share of negative consequences on capital markets and, as a result, our economy. Let's return to this thought as we elaborate upon another premise below.

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As the size and number of alternative investment vehicles has risen almost exponentially in the past several years, there have been rumblings of late, some mild indications, that the booming (Drexel-like, as it were) growth of this sector is to be curtailed. Whether manifest in regulatory commissions looking into alleged collusion among private equity funds, or whether we hear from high ranking officials about the need to regulate hedge funds (in a manner similar perhaps to consumer oriented banks and insurance companies?), one does begin to feel that certain wheels are turning.

Now, the rightness or wrongness of these enormously complex cases is beyond the scope of this article, (or any easy resolution for that matter). We would point out, however, that like Drexel and the high yield market it helped to create, alternative investment vehicles have provided valuable services to the U.S. economy, the diminution of which services (should such vehicles become more limited in their abilities to act) might have significant negative market and economic ramifications. Among many positive contributions of alternative investment vehicles, the more noteworthy include the addition of a major source of liquidity to financial markets, fortunately in time to offset the negative repercussions on public companies from our era's defining regulatory moment, Sarbanes-Oxley. This added liquidity has moreover contributed to capital investments and market efficiency (contrary, in fact, to the collusion argument presented), as the availability of capital sources beyond a handful of banks and large industry consolidators has vastly multiplied.



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That privileges are sometimes abused may be true enough, but the question is one of proportion, balance, and the general good, and we hope that the potency of all will not be limited by the (alleged) transgressions of very few. Granted, neither the cause nor the effect of an all-out collapse like Drexel's is anywhere close to manifestation. In the current situation, however, even a minor disruption across the board might have far reaching ripple effects. This, therefore, is strictly a note of early caution, as history does often repeat: regulatory reaction to the Drexel scandal circa 1990 led to a squeeze on leveraged lending and a liquidity crunch in debt markets; more recently, regulatory reaction to Enron led to Sarbanes-Oxley, which has hindered the flow of public equity capital on a number of levels. As we continue to hear regulatory rumblings on the heels of Amaranth and other situations, we should be mindful of the capital markets repercussions such rumblings have led to in the past.

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