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The way the dominos may fall: Causes and effects in the current markets

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It is difficult to imagine that a seemingly marginal financial segment like “sub-prime mortgages” could single-handedly be responsible for turmoil of such enormity that global central banks would utilize any and all tools at their disposal to preemptively, after-the-fact, or in “real time” stabilize capital markets and, towards the longer term, global economies. It does, however, appear that there has been an almost unprecedented domino effect, as may be unavoidable when financial markets are propped up by perhaps unprecedented liquidity, and this underpinning is shaken. The consequence, as witnessed by many industry observers, is a blow to the system that has struck well beyond sub-prime mortgages – and this despite a relatively strong economy and record-low corporate default rates. Here is the string of instabilities and causalities we have seen, in order:

1. Mortgage market disruption: Illiquidity in the sub-prime loan market, caused by and further aggravating a decline in property values, has led to substantial losses and erosion of capital for many banks, finance companies, and hedge funds. This capital erosion, through the multiplier effect of financial leverage that is common to financial institutions, has led to a vastly diminished ability for such organizations to extend new loans.
2. Credit market pressures: While the direct impact of this sub-prime mortgage exposure has been limited to isolated patches of the financial sector, more general uncertainty about the problem’s extent has led to more general credit market instability. Consequences have included the following:
 - CDOs, which depend on (a) continuing equity investments into their funds and (b) renewed access to warehouse lines from banks, in order to continue originating loans, have very substantially lost access to both. These CDOs and credit oriented hedge funds had until recently constituted not only the most aggressive but also the largest category of lenders in the leveraged loan market.
 - With such a large pool of market capital effectively crippled, debt deals in process have struggled to get syndicated, while new deals have been difficult to price. For financing commitments already in place, therefore, banks and other institutions have been stuck holding paper well beyond their targets, and this has in turn diminished their appetite for new paper even further.

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3. Equity market volatility: As a result of the above, new corporate debt issuance has been curtailed and the structures of new deals have become much more conservative and more costly for issuers. The impact of diminished access to low-cost credit capital has sent ripples through equity markets, where price volatility has reflected some of the underlying corporate finance risks:
- Uncertainty about commercial paper refinancings could cause near term working capital instability for some issuers, and further pressure the system of banks and other liquidity sources that would be called upon to backstop such disruptions.
 - Private equity funds that had played such a significant role in bidding up valuations in the M&A market of late, due to their access to attractive debt structures that leverage equity returns, are now seen turning more conservative and limited in their ability to drive equity values. (As this article is being written, Home Depot has announced a revised agreement with private equity firms seeking to acquire its wholesale supply unit, reflecting a 18% lower deal value.)
 - Corporate capital investments for growth seem for the time being more likely to be financed with equity than debt, which comes with a potentially dilutive impact to existing shareholders.
 - Existing debt structures that had previously cleared the market on the basis of future refinancing availability, may now be in jeopardy of default, which in turn could lead to bankruptcies or at the very minimum a need for dilutive equity infusions.
 - The requirement of equity capital to fill the gap of debt – in some of the ways listed above, or merely to fund previous commitments left open – could diminish liquidity in the equity markets, and could become a long term issue as equity sources get tapped out.

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Many market observers, however, seem cautiously optimistic at this time, that the fall of the dominos as described will right itself. Primarily, this perspective is supported by the continuing high level of general liquidity in the global markets which has been further supported by recent central bank actions. But even the most optimistic these days concede that the terms of new deals, after the dust settles, are likely to be a far cry from the aggressive structures of recent times (in terms of both leverage multiples and pricing).

There is also a further possibility we see, resulting from an extended domino effect, which could lead to a private equity and related market repositioning to spell new opportunity for many issuers. The cause and effect would be roughly as follows:

1. With a diminished market for large syndicated debt structures, many lenders may (and some have already started to) migrate to single-



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...also a further possibility for private equity and related market repositioning, leading to opportunities for issuers that had been marginalized or overlooked...

lender or “club” deals for smaller transactions and middle-market companies.

2. Because the number of large LBO transactions is likely to diminish for reasons noted, while the liquidity of private equity funds remains and needs to be put to work, we may soon begin to see private equity straddle into more venture capital oriented situations to generate target returns without the help of leverage.
3. In turn, venture capital funds that had recently deviated from their roots, behaving more and more like later-stage private equity (primarily because the opportunity presented itself), may be forced to come back home.

While we agree with others and don’t see either equity or debt terms attaining the frothy levels of recently hyperactive capital markets, opportunities for issuers that had recently been marginalized or overlooked as a result of such hyperactivity could increase, should any or all of the foregoing materialize.

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