

Ponzi's final exit

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Yes there were happy days indeed, those decades of liquidity and high finance. There was a high yield bond market expansion in the 80s that fueled a leveraged buyout boom... then the 90s evolution of structured financings that converted into instant cash slightly less liquid assets such as packaged credit card receivables, but soon opened up to mortgages of all kinds, and car loans, and then more esoteric assets like insurance premiums, tax credits, entertainment libraries, and trademarks. And when the potential investment uses failed to keep up with escalating liquidity, we invented assets to finance by tagging the names of projects with a “dot-com” suffix. Now that was just going too far... But we learned our lesson, and in the subsequent decade we focused primarily on funding structures with strict cash-flow based credit limits in the 12-15x range, and only for the soundest underlying business models in which we could also afford to do away with financial covenants. In light of the conservatism and responsibility which has come to characterize our financial system for so long, as illustrated, it comes as a shock to hear about a global Ponzi scheme approximated by its mastermind at plus or minus \$50 billion, (or about half of the current market caps of companies like Google and Cisco, and twice those of Amazon and Dell).

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In a recent Henry Blodget article at Silicon Alley Insider, a conversation with Silicon Valley legend Andy Grove is described, in which the former Intel Chairman, CEO, and third company employee, reflected on the strange notion of “exit” as a driving force behind the strategies of entrepreneurs, (which of course also holds true for their backers). “Intel never had an exit strategy,” he is quoted to say. This comment leads one to think back upon the financial trends described above, and the extent to which “exit” – rather than value creation through business fundamentals – played a critical role throughout. In the case of LBOs as far back as the 80s, for example, those highly leveraged deals presupposed a successful refinancing – not only of the sponsor equity but also of the junk debt at maturity if not far sooner. While debt is by its nature predicated on an eventual repayment, as opposed to the perpetual capital nature of equity, there is an important distinction between repayment of debt and its refinancing, in that the latter (like an equity exit) requires a counterparty to exit to. (We will return to the concept of a Ponzi scheme shortly below.)



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In the same way, the asset securitization structures that emerged in the 90s and grew like wildfire thereafter, were built upon a continuous source of refinancing (as opposed to repayment) of short term paper. The now notorious "dot-com" bubble, on another level but similarly, was based on IPO successes that would create quick flip opportunities for founders, their original backers, and even the IPO investors who knew that a rapid sale was certain to occur in a hungry market that would instantly bid up the stock price, which was banking on a still hungry (or hungrier) market subsequently to bid it up some more... and so on. The credit bubble that has now come to characterize our current malaise, has largely also been based on the notion of a deep and liquid market in which paper of all kinds could be easily offloaded, and the refinancing requirement for debt was this time no longer limited to junk bonds but also the bank debt that, back in the day, in the traditional LBO model, could at least have been repaid through a borrower's generated cash flow.

On a certain level, the difference between a concept like Bernie Madoff's, on one hand, in which existing investor returns are dependent upon a future investor's existence, and on the other hand corporate financings that depend purely on a healthy "exit" or "refinancing", is mainly a difference of disclosure. Had Madoff informed his investors through a prospectus upfront about the necessity of future investors continuing to buy in, in order to generate return of and on capital for previous investors, then his structure would have been remarkably similar to a perfectly legitimate "dot-com" IPO or, what's frighteningly worse, a highly levered senior debt position in support of a corporate buyout or recapitalization circa 2006. With this in mind, the Madoff scandal may come to signify more than the epitome of market excess, but the end of an economy fueled almost entirely by financial capital and, more precisely, the locomotive of liquidity that has pushed asset valuation without a commensurate underpinning of business or economic fundamentals.

In our new economic reality, in the post-Madoff world, we would not necessarily look for business planning and active strategic redirection to displace corporate finance strategy, but to assume a much more prominent role around corporate boardrooms and C-level suites than may for some have been the case in the recent past. We would look for highly strategic acquisitions to continue, and possibly even increase in number, but we would expect such



transactions to carry much more conservative valuations than has been the case, and we could also expect to see a greater use of long term and incentive-based payment structures such as stock-based consideration and earn-outs, rather than a seller's quick exit through pure cash transactions... and buyers left holding the baggage alone. In the meantime, reports of a more selective financial sponsor community have already been widely circulated, and while this will probably make sellers less instantly wealthy, it should in the longer term lead to better deals, with healthier balance sheets, less pressure on costs, and better ability to compete in a global economy.

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It may be, therefore, that the current economic shakeout, as painful as it now seems (and actually is), will in a few years be deemed a healthy and necessary event, from which future generations (and maybe even our own) will benefit. While such seemingly bizarre optimism goes counter to the precept that history repeats itself, a truth that was manifest as recently as the variety of back-to-back bubbles described herein, it is also true that the current economy seems literally to have no historical precedent. This bubble burst, unlike its many predecessors, has not left new industries in its wake – such as at one time railroads, oil, electrical utility, broadcasting, computers, or the Internet – to drive future prosperity after a necessary housecleaning. Instead, this shakeup has left us with only two inheritances: one, a massive inventory of vacant capacity that may or may not again be utilized and that will thus force us to be inventive; and two, a shock to the system of such magnitude that lasting lessons are bound to be learned... even by Wall Street types.

By Dan Ramsden
Near Earth LLC



SPECIALISTS IN SATELLITE, MEDIA AND TELECOM INVESTMENT BANKING

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