



Life After the Credit Crisis

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Much has already been written about the credit crisis being a direct culmination of the mispricing of risk. The downturn will likely involve a re-pricing of risk and significant restructuring of the financial landscape. This process brings to mind economist Joseph Schumpeter's idea of creative destruction whereby innovation accompanies destruction of the old and signals the next phase of growth.

For nearly a decade, lax monetary policy made credit easily available. To a certain extent, this facilitated the use of leverage to mask shrinking profit margins in increasingly overcrowded hedge fund strategies. This use of leverage substantially increased systematic risk. Between 1995 and 2007, AUM per fund for Equity Market Neutral and Long/Short strategies increased by a factor of 15 yet average daily return of these strategies nearly halved from just less than 1.4% to 0.7%. Among the worst performing strategies in 2008, the Equity Market Neutral strategy had a cumulative return of -40.3%. The re-pricing of risk will likely entail a higher cost of capital than before the crises. Financial firms whose business models depend on cheap access to funding in wholesale markets will either be forced to adapt or disappear. Although the hedge fund sector as a whole will likely experience a slight increase in asset inflows after 2008's negative year (the first year of net asset outflows since 2002), some hedge fund strategies, including Global Macro, Credit, and Distressed, should do well going forward.

The consequences of simultaneous deleveraging by banks, firms, and households will depress asset prices significantly and will have broad and long-lasting implications for the financial industry. Most notably, the wealth destruction from the steady collapse of residential real estate prices (which nearly doubled between 1997 and 2007) and the continual precipitous decline in equity markets will likely increase investors' risk aversion for years to come. Moreover, it is expected that as many as one-third of hedge funds will be liquidated as the current crisis deepens; from January to October of 2008, 17% of funds within the Credit Suisse/Tremont database ceased operations.

The financial sector will undoubtedly emerge from this downturn smaller and less leveraged. This retrenchment should hardly seem surprising in the context of the sector's earlier growth and excessive use of leverage. The financial services industry's share of corporate profits in the US rose from about 10% in the early 1980's and peaked at over 40% in 2007; as of 2008, the financial sector accounted for 40% of total US private sector debt. Unviable firms must ultimately choose to cease operations either through liquidation or asset sale. Some short-sighted management teams will likely fail to realize this choice until too late. Distressed sales will facilitate the transfer of assets, talent (via liftouts), and other resources from unviable firms to those that are the most innovative and nimble, and therefore most likely to capitalize on the sector's next big growth opportunities.

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To a certain extent, the government realizes this and has included certain small business tax provisions in President Obama's stimulus plans as a catalyst to industrial restructuring and growth. Typically, if a taxable corporation converts to an S corporation, the conversion is not a taxable event, so long as the newly converted S corporation holds its assets for ten years. Otherwise any built-in gains (the difference between the fair market value of the assets and their tax basis at the time an S corporation election was made) that existed at the time of the conversion are subject to the 35% corporate level tax. A provision in the President's stimulus bill temporary reduces the recognition period from ten years to seven years for sales occurring in 2009 and 2010. From an M&A perspective, this bill provides much needed, albeit temporary, tax relief that could provide certain firms with access to needed capital through the sale of appreciated assets, or help facilitate asset sales or acquisitions of S corporations during the next two years.

Industry experts expect M&A activity during 2009 to be concentrated in the financial services, automotive, consumer products, and retail sectors.

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