ALPHA + LEONIS
PARTNERS

FROM THE CIO

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TRIGGER WARNING

The intricacies of past and present banking crises as we delve into their common themes, exploring the factors that led to significant financial disruptions. Valuable insights from historical events help us better understand the current Silicon Valley Bank crisis and its potential implications.

How central banks, including the Federal Reserve and Swiss National Bank, are taking decisive action to prevent contagion and stabilize markets in response. We explore potential outcomes of their interventions and the critical role they play in maintaining financial stability.

We comment on the evolving landscape of the financial industry in the aftermath of banking crises, and identify unique investment opportunities that arise during times of turmoil. Find out how long-term market implications and industry dynamics can shape the future of capital allocation, private equity, and technology adoption.

LIFEGUARD ON HEIGHTENED ALERT

During my career, there have been three systemic related banking system failures: the 1988/90's S&L Bailouts, the 2007/08 Global Financial Crisis ("GFC") and now the smaller Silicon Valley Bank ("SVB") and Signature Bank "crisis". In each of these times, significant losses were incurred by the wider set of public shareholders and bondholders.

Despite the markets getting triggered by some "pattern recognition and Post Traumatic Stress Disorder ("PTSD"), it is important to remember that, in times of significant dislocation in the banking/capital markets, that is when longer-term private equity type investors and "Warren Buffet types" or White Knight Capital often step in and create compelling opportunities to capture exceptional returns. [1]

[1] In the aftermath of the S&L crisis (1989) Bank United was purchased by Lewis Ranieri et al. In the 1990s "crisis capital" was provided to Citibank in the form of a Convertible Preferred and similarly in the late 1990's rescue capital was provided to buy a Japanese Bank called Shinsei Bank by Chris Flowers. In each of these private equity type financings, private investors ultimately realized MOICs between 2.5 and 5 times cost.

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1 HISTORICAL CONTEXT - BANKING CRISES AND THEIR COMMON THEMES

Each of these series of events represented a "crisis in confidence", errors in risk management and, ultimately, revealed misdeeds, frauds, and conflicts of interest. System-wide breaks also triggered policy reforms, corrected malinvestment, and provide a fine illustration of the Austrian economist Joseph Schumpeter's "creative destruction" in action. Even though the social triggers (actually tweets from Peter Thiel in the recent case) and the consequences are similar, the underlying fundamental causes and the speed and magnitude of policy responses are different in each case.

To me, it is important to study these past examples and to decipher aspects of each to gain some wisdom to understand the longer-term implications. Without getting too deep into the history, I believe that the origins of the situation today (SVB et al.) are more similar to the origins of the S&L crisis of the late 1970s and 1980s, more so than the GFC of 2008.

Not to oversimplify the GFC, but it was effectively an unwinding of over-leveraged credit exposures that were propped up and magnified by continuing declines in interest rates that forced/incented investors to take on more and more credit risk to earn returns on thinning margins. The "leverage upon leverage" on dubious credit quality assets ultimately crumbled and left many large systemic financial institutions in shambles forcing government bailouts to protect the systemic stability of the economies around the world. This was a global ***credit crisis***.

On the contrary, the S&L crisis was initially triggered as a ***rates crisis*** that later turned into a real estate and asset quality crisis, too. The reason why I think that this example is more similar to what we have seen recently is that the breaking of balance sheets (in both the S&L crisis and the SVB situation today) was predominantly instigated by the sharp increase in rates as an attempt to curtail elevating inflation. The S&L crisis had multiple causes, but the original catalyst can most likely be traced back to the Paul Volker draconian rate hikes and punitive 20% interest rates to kill the viral inflation of the late 1970s. High rates increased the funding costs for banks and concurrently decreased the asset values of the loans and fixed-income securities they held. It was an interest rate risk and asset liability funding/cost mismatch and a similar set of catalysts to today's SVB situation.

I read a salient quote the other day, which was, "The Fed will raise rates until something breaks".

The irony is that, on the one hand, the Fed's previous priority was to break inflation, but now it is waking up to some broken glass on the floor. Over the previous weekend, the dish cabinet rattled violently against the wall. Markets feared that the entire cabinet might fall over and that instead of dealing with inflation, the Fed would have a bigger problem cleaning up an entire floor of broken glasses and dishes.

2 CENTRAL BANKS RESPOND - PREVENTING CONTAGION AND STABILIZING MARKETS

As a result, the Fed immediately stepped in and not only protected the deposit base of SVB to the insured maximums but went beyond that and effectively protected the entire deposit base, even the uninsured portion. Moreover, its actions have now prioritized adding liquidity/bailing out SVB's underwater bond positions to prevent a contagion of bank runs. Estimates show that the Fed added $300bn in liquidity last week.

Steering the course in rate-driven crises

The Fed effectively "blinked" when it realized the cost of "too much too fast" on the rate hiking schedule.

The same "blinking" happened in Switzerland this week, too when the Swiss National Bank (SNB) agreed to provide Credit Suisse with a "lifeline" of $54 billion to avert a spiraling decline in confidence in one of Switzerland's systemic banks. This also has forced the merger of UBS and Credit Suisse as a regulatory-led balance sheet bailout of one of Switzerland's systemic banking organizations.

In the next Fed Meeting (starting March 21-22), we will see whether the Fed has backed off its previously telegraphed hike of 25-50 basis points. We expect that it will. Expectations of marginal heating of the economy have shifted to increasing probabilities of decelerating growth/recession and this supports a policy with more accommodation which means more liquidity being injected into the global banking system; a complete about-face from the previous tightening path many Central Banks were on.

So, unlike the GFC, which was a credit crisis of systemic proportions, the current SVB banking crisis is initially a rate-driven crisis. The Fed's early intervention this time around was effectively to avoid the scenario of where a rates crisis would metastasize into a larger credit crisis that would take a longer period to repair.

3 NAVIGATING THE FUTURE - MARKET RECOVERY AND EVOLVING INDUSTRY LANDSCAPE

This is not to say that everything is fine and it's back to "business as normal". SVB did have a systemically important role in the venture capital industry, and its implosion will take some time to heal and for other providers to step in and take its place.

Eyeing the remnants of SVB's Financial Fallout

The large distressed/vulture shops like Apollo, Oaktree, Buffett etc., are likely already circling above the carcass of SVB's assets and loan portfolios which are currently in the hands of the Federal Deposit Insurance Corporation "FDIC".

Just like in the 1990s when the Resolution Trust Corporation "RTC" was created by the US government to restructure the S&L industry, I expect the RTC to be reactivated to work on ultimately returning these assets to the private sector over time.

4 CONCLUSION: SEIZING OPPORTUNITIES REQUIRES ADAPTING TO CHANGE AND CAPITALIZING ON TURMOIL

Longer term, the creative destruction process is a healthy set of hurdles for capital formation of early-stage companies, which probably got accustomed to "easy money" that was available up to and during the Covid pandemic. Higher costs of capital and less capital availability tend to mitigate malinvestment risks and effectively winnow out inferior ideas from getting capital.

The markets now will have some careful confidence rebuilding. Rate pressures may have been alleviated near term and this will support equity market stability especially in the areas of the market that have the most rate sensitivity which are long duration strategies such as growth stocks. Cyclicals and/or value stocks (near-term cash flow positive stocks) will likely underperform as fears of a recession/harder landing might dominate investor sentiment.

Tech titans adapt: reshaping labor and harnessing the power of AI innovations

Large-cap tech continues to reverse what was aggressive hiring in the low-rate environment of the pandemic, but this is alleviating some of the labor shortages that had previously constrained small cap tech hiring. Furthermore, the accelerating competency of ChatGPT and Open AI is gaining substantial momentum. We continue to believe in the accelerating long-term power of these knowledge economy innovations and see the widening of "use cases" having powerful productivity consequences and deflationary implications. Technology such as this is an important development where the world's developed economies face structural demand declines due to declining birth rates below replacement and an inevitable population decline. We predict that many developed market economies will alter their immigration policies to encourage immigration into the developed markets so as to offset their declining populations and eroding tax bases.

Private equity, specifically strategies with high dependence on leverage, might slow near term as it will take some time for robustness or aggressive lending to LBOs to return.

But with that said, the larger money center banks (with JP Morgan as the poster child) are all beneficiaries of massive liquidity inflows away from the regional banks and this liquidity will seek deployment into higher yielding assets which we expect will ultimately reactivate lending starting with the larger types of credits that have recession resiliency like the consumer durables, food, healthcare, Telcom/services, and business services. In macro conditions where top line growth slows and or inflation eats at margins, these are the conditions that reactivate the merits of mergers and acquisition and consolidations of certain industries. This is an environment where the bigger entities seek out more aggressively to acquire smaller niche growth companies.

Within our sample of portfolio companies, (several hundred) ironically, we see continuing strong fundamentals in earnings and revenue growth occurring in the majority. We suspect that this is mostly because these companies are offering technology-oriented solutions that combat higher labor costs and higher material costs. In short, inflationary pressures are leading to accelerating technology adoption to improve efficiencies.

Of course, we are aware of the continuing risk factors in the markets despite the decisive stand the Fed and other Central banks are now taking to stabilize confidence.

We always seek to maintain a balanced emotional perspective and recognize that there are always exceptional opportunities in times of turbulence for longer-term patient capital allocators.

Respectfully,
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