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The Fed, Capital Markets and M&A Turbulence: Crash or Soft Landing

Guest and Dorsey Panelists

Carl Comstock, Vice President - Special Situations, Intrepid Investment Bankers LLC

Erin Bryan and **Eric Lopez Schnabel** Dorsey & Whitney LLP

Program Materials

PowerPoint Presentation

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Carl Comstock, Intrepid Investment Bankers LLC
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November 14, 2023

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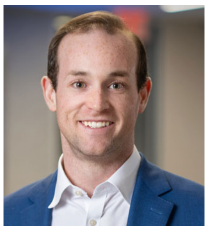

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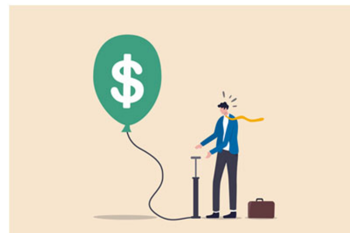
Agenda

- **Part 1 – Economics: Numbers For and By Lawyers**
- **Part 2 – Recent Events Impacting The Global Economy**
- **Part 3 – Response to Interest Rates and Legal Consequences**
- **Part 4 – Conclusion: Soft Landing or Crash**

Agenda

- **Part 1 – Economics: Numbers For and By Lawyers**
  - **What is Inflation?**
  - **Three Types of Inflation**
  - **Two Metrics for Measuring Inflation**
  - **Controlling Inflation and the Federal Reserve**



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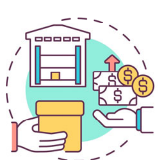
Three Types of Inflation

- **Economists break inflation out into three distinct types:**



Demand-Pull Inflation

Cost-Push Inflation

Built-in Inflation

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Demand-Pull Inflation

- Demand increases, supply decreases/remains stagnant
- Forces causing demand-pull inflation
  - A strong economy
  - Supply shortages (See Covid-19 Pandemic)
  - Rapid increase in monetary supply
  - Consumer expectation and speculation
- The Great Recession and the demise of mortgage-backed securities is a classic example of demand-pull inflation

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Cost-Push Inflation

- Unrelated to consumer demand, production costs rise
- Drivers of cost-push inflation
  - Labor shortages
  - Raw material cost increases
  - Natural disasters
  - Regulatory changes
- The 1970s Energy Crisis was largely responsible for the cost-push inflation that occurred during that time period

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Built-In Inflation

- Least discussed type of inflation
- Companies raise wages or salaries and attempt to maintain profit margins by raising prices
- Also known as: wage price spiral

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Coffee Shop Hypothetical

- Your favorite coffee shop increased prices due to rising costs of coffee beans - You are a victim of cost-push inflation.
- The coffee shop increases the barista's salary and passes the cost on to you via more expensive muffins - You are a victim of built-in inflation
- You still buy a muffin and coffee every morning - You are engaging in demand-pull inflation

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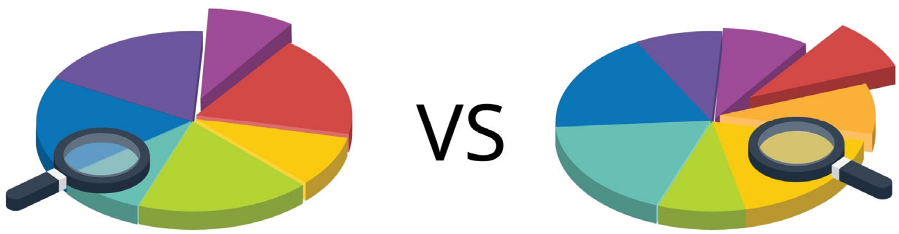
Two Metrics for Measuring Inflation

- Economist utilize two primary metrics to quantify inflation



PCE
Personal Consumption Expenditures

CPI
Consumer Price Index

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Controlling Inflation - The Federal Reserve

- Dual mandate from Congress to the Federal Reserve
  1. Maintain stable prices throughout the economy (manage inflation)
  2. Support maximum employment
- The Federal Reserve seeks to manage inflation by influencing interest rates
  – Manipulating the Federal Funds Rate helps the Fed accomplish this goal

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Inflation and Interest Rates: Past 40 Years

- **Before 1990, the Fed did not explicitly set the Federal Funds Rate (indirect influence)**
- **Reached as high as 22.36% in 1981**
- **2008-2009, nearly reached zero when quantitative easing was put into effect.**

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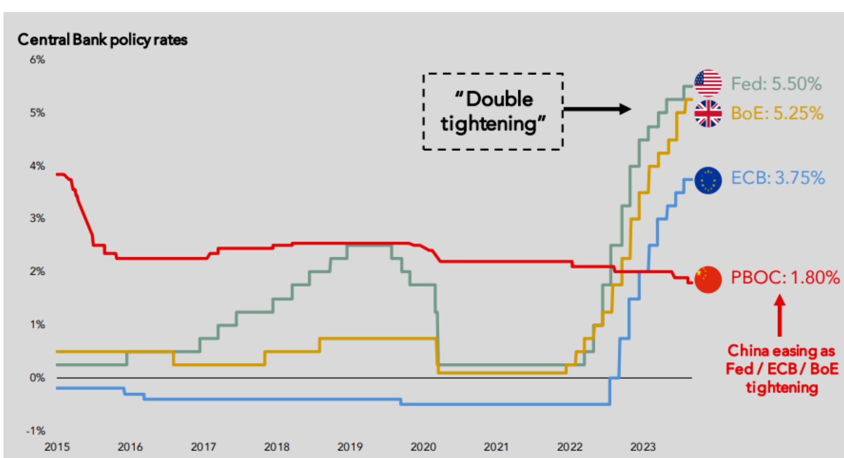
Inflation and Interest Rates: Past 8 Years



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Agenda

- Part 2 – Recent Events Impacting The Global Economy
  - Covid-19
  - Russia's Invasion of Ukraine
  - Silicon Valley Bank Collapse
  - Israel-Hamas Conflict

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Covid-19 Pandemic

- Pre-Covid
  - 2019 - Federal Funds Rate between 2% and 3%
- Pandemic Fears Cause Fed to Act
  - Federal Funds Rate slashed to Near 0%
  - Government funds pumped into economy (stimulus packages)
- Post-Covid Trends
  - More than 10 rate hikes bringing the Federal Funds Rate north of 5%

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Russian Invasion of Ukraine

- Fuel and food prices instantly began to surge
- Russia's central bank continues to raise rates to combat the weakening Ruble
- From a domestic perspective, debate has swirled around whether the Fed should slow the increase of the Federal Funds Rate amid uncertainty about the duration and scope of the conflict

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Silicon Valley Bank Collapse

- What is a run on the bank?
- Not your typical bank run. Why was SVB so susceptible?
- Containing the problem. Fears of a larger banking crisis

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Israel-Hamas Conflict

- RISK: Higher oil prices = Greater inflation = Higher interest rates
- Uncertainty remains.
- If the conflict expands to involve neighboring countries, some forecast a price spike to $150bbl

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Agenda

- Part 3 – Response to Interest Rates and Legal Consequences
  - Bank Lending Trends / Legal Implications
  - Capital Markets Trends / Legal Implications
  - Bankruptcy and M&A Trends / Legal Implications

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Bank Lending Trends - Total Industry Impact

- Shrinking margins
- Lending slows, bank revenue follows
- Lower net interest margin

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Bank Lending Trends - Impact on MegaBanks

- More resilient than the smaller regional banks
- Other lines of business such as investment banking and wealth management provide a bigger cushion
- Credit cards drive higher net interest margins


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Bank Lending Trends - Impact on Smaller Regional Banks

- Profits drop for midsize regional banks
- Smaller banks are merging
- Efforts to get smaller and more efficient

Regulatory Response to Rising Interest Rates and Bank Failures

- Stress testing tools
- Surveillance tools
- More attention on smaller financial companies
- Investigate interlinkages
- Understand system wide liquidity risks

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Capital Markets Trends / Legal Implications

- **Impact on equities overall**
- **Impact on venture capital investments**
- **Impact on debt markets**
- **Impact on M&A**
- **Impact on IPOs**

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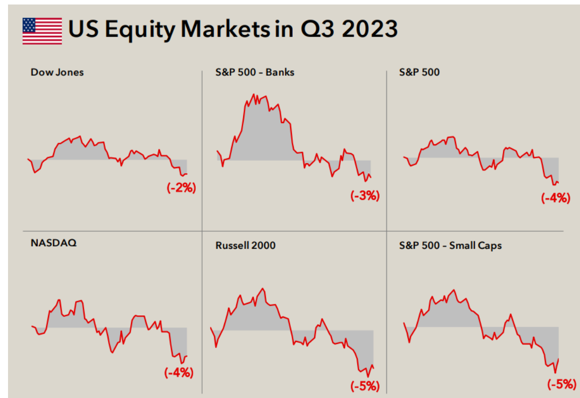
Impact on Equities Overall

Three main ways high interest rates affect equities:

1. Reduces corporate profits
2. Decrease in present value
3. Raises risk premium



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Decrease in VC Investments

2022

- $107B decrease from 2021
- 65% drop in funds raised in Q4 2022 as compared to 2021; lowest Q4 Since 2013

2023

- 2023 Q3 continued decline, raising only $31B
- 31% fewer deals completed in Q3 2023 as compared to Q3 2022

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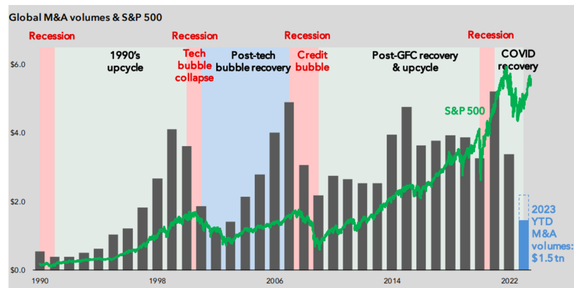
Impact on M&A

- **Deal-Making Slowdown**
  - **First six months of 2023, global deals down 37% from 2022**
  - **Marks slowest first-half period since 2020**
  - **Bain estimates 39% decline in global deal making volume from 2022 to 2023**



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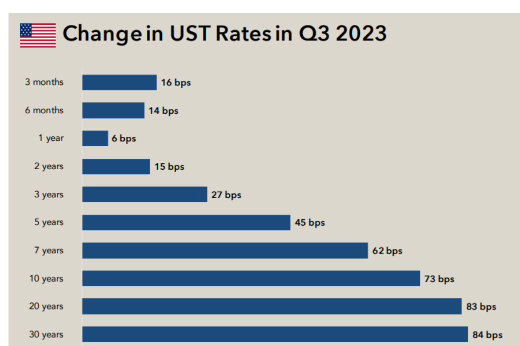
Impact on Debt Markets

2022: Debt Markets Slowed

- **High-yield interest rates doubled from 2021**
- **U.S. Debt Markets raised $1.7T in 2022, down from $2.6T in 2021**

2023: Debt Markets on the Rise

- **U.S. debt capital markets raised $379B in Q3, $12B up from 2022**



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Impact on IPOs

2022 - Slowest IPO Market in Two Decades

- 27 traditional IPOs in 2022, down from 338 in 2021

2023 - IPO Slow Trend Continued

- As of Q3, only 9 traditional IPOs completed

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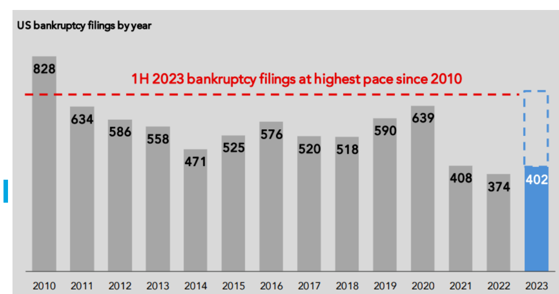
Impact on Bankruptcy

- 12 bankruptcies per month in 2023, nearly twice the monthly average between 2005 and 2022 of 6.4. (Companies over 1B in assets)
- Delaware and the Southern District of Texas accounted for 39% and 32% of all bankruptcy filings in first half of 2023, respectively.
- In first 9 months of 2023, commercial Chapter 11 bankruptcies soared 61% year over year.



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Notable Bankruptcies in 2023

- WeWork
- Silicon Valley Bank
- Bed Bath & Beyond
- Party City

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Are Interest Rates Solely to Blame for Rise in Bankruptcy?

- Consumer demand is being driven down
- Rising levels of consumer credit card debt
- Resumption of deferred student loan payments
- Stimulus savings gone or going fast
- Lagging impact of cost pressures following Covid-19
- Cost of capital is more expensive, more pressure on borrower
- Less tolerance/flexibility from lenders

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How Will Interest Rates and M&A Trends Impact Bankruptcy Exits?

- **Rising interest rates have decreased availability of acquisition financing and financing for distressed acquisitions are typically hardest hit**
- **Lower valuations impact return to lenders in third-party (363) exits**
- **These factors limit lenders ability to pursue bankruptcy asset sales and are more likely to "take the keys"**

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Impact on M&A Transactions / Legal Implications

- **Deferred Payments**
- **Escrows**
- **Post-Closing Adjustment**
- **Private Equity Deal Terms**
- **Venture Capital Investment Structure**

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Impact on Deferred Payments

- **Reasons for deferred payments**
- **New expectation to receive interest on deferred payments**

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Impact on Escrows

- **Reasoning for escrow**
- **Negotiation of interest on escrow funds now important**

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Impact on Post-Closing Adjustment

- New expectation to receive interest on adjustment payment
- Locked-box model becoming more prevalent in Europe

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Impact on Private Equity Deal Terms

- Banks less willing to make bridge loans
- Remedy → Alternative financing methods
- Potential issues with alternative methods

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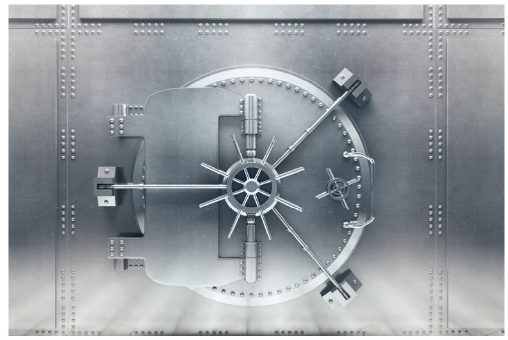
Impact on Venture Capital Investment Structure

- SAFES vs. convertible promissory note
- Resurgence of convertible promissory note



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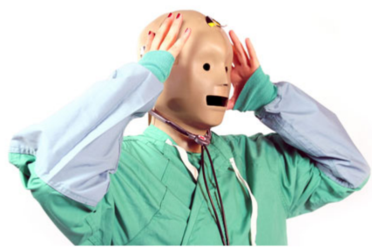
Agenda

- **Part 4 – Conclusion: Soft Landing or Crash**
  - **Two possible outcomes of current market conditions**
    - **Soft Landing**

      VS.
    - **Economic Crash**



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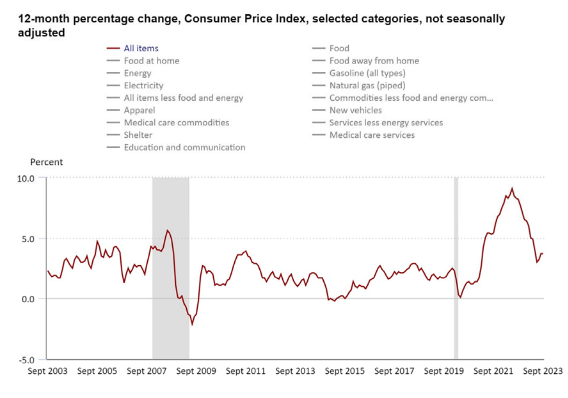
Most Economists Now Predict a Soft Landing

- **Inflation continuing to decline**
- **Federal Reserve finished raising interest rates**
- **Robust labor market and economic growth**



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Potential for Crash - Risks Threatening Soft-Landing

- **Interest rates remain too high for too long**
- **The economy stays hot amid raising interest rates**
- **Energy prices**

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