FINANCIER WORLDWIDE corporatefinanceintelligence

Dealmakers' Forecast 2008

For this annual feature, Financier Worldwide has again gathered the opinions of the corporate advisory and dealmaking community to explore their insights into current and emerging trends as we enter the new year.

Mergers & Acquisitions

Private Equity & Venture Capital

Capital Markets

Bankruptcy & Corporate Restructuring

Sector Analysis

MERGERS & ACQUISITIONS

JIM CONNOR,
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▶ OUTLOOK FOR M&A IN 2008

In 2007, deals started out in good shape, activity was solid and liquidity was readily available. Deals were often capitalised in excess of 80 percent debt, and why not? Readily available leverage, being the mechanism to translate a modest investment into enormous returns, turned the most conservative, strategic buyers into financiers of very highly leveraged deals. But all good things must end, and the subprime loans credit 'revelation' sent us all back to reality.

Coming out of this turmoil we see a number of very positive factors that should have a favourable effect on the M&A market in the United States. The first is the currency. The weak dollar, particularly at the current levels, ought to drive foreign currency investment (the larger private equity funds) into the US in droves. Why not use a foreign currency, invest in a US dollar based cash flow business, and increase your returns as the dollar strengthens when these funds look to harvest an investment in, say, three years? It seems to make a lot of sense, all other things being equal.

A second factor affecting a strong market is interest rates and liquidity. Admittedly, it is difficult to finance most deals now. Private equity funds will likely play a larger role in the capital structure. A 50/50 ratio as the benchmark does not seem that unreasonable as we begin 2008, and some would say this is prudent. The amount of idle funds sitting in private equity is still phenomenal. These firms are run by bright guys who will inevitably come up with a new product, a new spin that will enter our jargon in the next six months or so. We'll all be doing deals a little different way, but they will get done.

Finally, there is new money: the so called sovereign funds – primarily Middle East oil money in Saudi Arabia, Qatar, United Arab Emirates, and Kuwait. Some have estimated that the investments controlled by the top 35 sovereign funds exceeds $1.4 trillion. That means plenty of liquidity, and with estimates of oil dependence at a minimum of 100 years, this can be patient money. While some of the investments these funds hold are sometimes difficult to track, many funds have already invested in the larger traditional large private equity funds. The $7.5bn investment in Citicorp by the Saudi's is a mere drop in the bucket for them. All of this funding will continue to come our way in 2008, and why not?

If there is any merit in the three factors above, the US is set for a robust M&A market in 2008. It likely begins with more mid-market deals until capital structures can reflect a lower equity percent than will likely be the case in early 2008. When the markets put the credit crunch them, the larger deals will begin again, perhaps by mid 2008. ■

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▶ NEW BATTLES IN M&A NEGOTIATIONS

The M&A market for 2008 opens on the heels of a rollercoaster 2007. The first half of 2007 chugged smoothly upward with mega deal after mega deal announced primarily by private equity funds. The ride downward in the second half of 2007 was much less enjoyable. The credit crunch plunged those same deals into attempted terminations, followed by renegotiations or law suits. The business pages detailed numerous troubled deals, including those for Sallie Mae, Genesco, Harman International, Avaya, Home Depot Supply, Accredited Home Lenders, PHH, Acxiom and United Rentals.

Deal certainty is crucial to all parties involved and the examples of deals gone bad are so vivid that we should expect M&A negotiations in 2008 to be very hard-fought and to take a number of different paths.

To figure out where M&A deals are going in 2008, it is helpful to ask "How did we get here?" In the not so distant past, M&A deals included financing contingencies that permitted buyers not to fund if their lenders could not – or would not – fund. Moreover, buyers commonly used shell companies as parties to the acquisition agreement with only the reputation of the private equity fund as collateral. In short, the sellers took the financing risk. As the M&A markets heated up, buyers competing in hot auctions agreed to provide equity commitment letters or guaranties and signed deals that did not include a financing contingency. In return, the buyers insisted on their liability being capped under a so-called reverse break-up fee.

When the credit markets began drying up, reverse break-up fees became negotiating weapons. In the Home Depot Supply deal, the buyers threatened to walk from the deal and pay the reverse break-up fee. But, at the same time, the seller, Home Depot, had already committed to use the proceeds from the deal for a share repurchase program. The renegotiation resulted in a $2bn decrease in the purchase price and Home Depot's agreement to help finance the deal. In other deals, there have been reports of banks offering to pay all or a portion of the reverse break-up fee on behalf of their buyer-clients rather than face potentially greater losses if the transaction closed and they were forced to fund.

When deals like these turn sour, the agreed remedies become tremendously important. In Silver Lake's purchase for Avaya, which was rumoured to have had troubles, the parties agreed that the seller could force the buyer to close and fund, which they did. In the United Rentals deal, Cerberus and URI each sued, seeking a ruling that its interpretation of the acquisition agreement was correct; Cerberus claiming the reverse break-up fee was the sole remedy and URI claiming its entitlement to specific performance to force a closing by Cerberus.

Notwithstanding the credit crunch, we should expect that private equity funds, hedge funds and others will continue to do a lot of deals in 2008, but we should also anticipate negotiations to be very hard-fought as each party attempts to strike a difficult balance. Look for buyers to attempt to do deals with financing contingencies, banks to return to commitment letters with traditional closing conditions, and sellers to move in the opposite direction looking for specific performance clauses that force fundings or, failing that, pay significantly larger reverse break-up fees. ■

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PRIVATE EQUITY & VENTURE CAPITAL

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▶ PRIVATE EQUITY OUTLOOK 2008

Twelve months ago the private equity industry asked itself whether 2007 would be another record breaking year, as 2006 had been. For the first six months of the year this question could be answered with a 'Yes' as all sectors of the market maintained their momentum and investors continued to put large amounts of capital to work in the industry. The second half of the year has looked rather different. Turmoil in the US real estate market, higher interest rates, less confidence on the global stock markets, and lower global economic growth have all had a negative impact on the private equity sector. The implications of these factors for the private equity industry will also be important for 2008.

Given a changing market environment, general partners will need to put special emphasis on their portfolios: they are now required to increase the value of the companies despite the continuing downturn in the market. In addition to implementing restructuring and repositioning initiatives, active GP ownership of companies also allows the portfolio firms to capture new growth potential more quickly and effectively. A slowdown in the market will shift the focus on to more active GP work rather than on pure financial plays with low operational involvement.

On the limited partner side the market will continue to experience high levels of capital inflow, and the flight into high quality fund managers will continue. As on the general partners side, fund investors will be managing their portfolios more actively, and are likely to try to focus on a smaller number of relationships with higher commitment sizes. First time funds with undeveloped or unstable track records will face long and challenging fundraising times.

Nevertheless, despite the current negative sentiment on the market, private equity will attract additional capital inflow from geographies that historically had little or no private equity investment activity up to now. Australia, Japan, and the Middle East are becoming increasingly important in any GP's fundraising calendar. With increasing deregulation we can also expect Indian and Chinese private equity investors to become increasingly active.

As in any cyclical market, quality players will prevail. Private equity investors will continue to put trust in the market as they have seen that investments in a more rational environment have outperformed the market. Private equity sponsored companies are likely in general to remain better and more efficiently managed than their peers listed on the global stock markets. Now more than ever, it is up to the GP to show that operational improvement is the key to success. ■

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▶ PRIVATE EQUITY IS ALIVE AND WELL

"The reports of my death are greatly exaggerated." If the private equity market could speak, would it echo the words of Mark Twain, following the mistaken publishing of his obituary? Although it is perhaps inevitable that the market's perception of the impact of US subprime on leverage finance and private equity will be heavily influenced by how the mega deals have fared in the wake of these issues, are these deals really representative of the whole market? If not, what might this tell us about how private equity might react to these issues?

Mega deals will inevitably attract much publicity and will have a proportionately large impact on industry figures, but the aggressive leveraging and deal structuring which became the norm at the mega end of the market is not indicative of the entire market. Many mid-market transactions (from £20m-£250m enterprise value) were structured on a more traditional basis. Many of these transactions would have a traditional leverage finance structure with an amortising Term Loan A, a bullet Term Loan B, and Term Loan C, and a mezzanine tranche. These transactions typically would not have been structured to stretch the debt servicing capacity of the borrower as far as possible, and as a result many of these transactions would have been syndicated in the traditional banking market and found a warm reception.

Although it might not be possible right now to structure a leveraged buyout with just a large non amortising Term Loan B, and a sizeable junior mezzanine PIK facility with its interest rolling up against a future pay day, for many mid-market houses which never sought this type of deal structure, this is no change at all.

Banks might be comfortable with mid-market PE houses' desired debt structure for their own book, but their appetite to underwrite the debt and find buyers is severely limited. Many private equity houses are now either talking simultaneously to a number of banks about their desired debt structure and effectively 'self syndicating' their debt, or are engaging independent debt advisers to do this for them, thus reducing the risk of a failed syndication.

Mega deals might be dead for now, but expect to see the big private equity firms moving to mid-market deals where there is still good business to be done. ■

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▶ SECTOR EXPERTISE AND TANGIBLE VALUE-ADDED SOLUTIONS HOLD KEY TO CURRENT AND FUTURE PE DEALS

The impact and fallout of the credit crunch has been well documented. Banks are saddled with around €100bn worth of debt in Europe alone which cannot yet find a new home, according to some reports. Additional issues include postponed or hung syndications combined with a challenging risk, pricing and credit market.

But we are seeing some good news. Despite all these pressures, some CLOs are being priced and LBO transactions are still being financed and closed. We are seeing a step-change in how these deals are being structured and sold onto banks and funds in the market post credit crunch. To start with, pricing and documentation are more conservative (the emergence of covenant-lite seems an age away) and leverage ratios have dropped a gear or two, reflecting the caution in the market. Second lien has disappeared altogether. Perhaps the main change for sponsored transactions is the need to shift from an EBITDA leverage to evidencing an ▸▸

'added value' or 'EBITDA growth story' in a transaction, to appeal to investor groups.

Those transactions successfully syndicated today are typically in trusted, non-cyclical and reliable growth sectors, where investors can see a strong underlying business that will de-leverage readily through the obvious and tangible growth prospects of the company. Showing how the business will be improved and grow is an essential part of this story.

Lenders and institutions that have direct operational experience in key sectors, such as aerospace, healthcare, media, and manufacturing, can share expertise with sponsors to show how growth can be realised in their company portfolios and optimise financial structures with knowledge gained in the sector. Transactions, such as Melita Cable, GDT and Docu Group, are examples of deals with market-friendly structures that syndicated well, even with pre-credit crunch pricing.

The immediate impact of the credit crunch has clearly rationalised the market, which will continue to cool well into 2008, but it does not mean deals won't be completed. Far from it. For a time, it will be smaller, club deals that get done and lenders with strong balance sheets, including local market banks, will play a prominent role. The German leveraged finance market, for example, has been very active and investors will always be on the look out for cheap assets. One thing is for sure though – deals that can communicate a strong growth story and are structured in a way that meets investor requirements will have the most demand. Utilising comprehensive sector knowledge to create growth opportunities could be the deciding factor. ■

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▶ EMERGING MARKETS PRIVATE EQUITY FUNDS

Emerging markets have been the locus of innovative developments in the structuring of private equity investment funds and most recently this can be seen in the innovative use of debt, including both senior and subordinated debt tranches. Whether driven by (i) the desire to reduce the risk of investing in what are seen as less secure markets by achieving priority of payment afforded to creditors or (ii) the internal policies of certain investors, especially specific international financial institutions encouraged or restricted to providing credit, investors in emerging markets private equity funds are increasingly willing to hold notes. Private equity investment fund financing involves unique considerations unlike project or corporate finance, for example. This is true in regard to terms of repayment, the characterisation of events of default and the security package available to lenders.

Private equity investment funds have restricted liquidity and the terms of repayment of both principal and interest must be structured to conform to the timing of dispositions. Thus, even senior debt repayment schedules must be linked to the timing of dispositions, which is not known at the time the debt is incurred. Subordinated tranches may be repayable only when senior tranches are redeemed or upon meeting certain financial 'gating' thresholds. Careful tax analysis, particularly where there is an 'up-side', is required to ensure tax treatment as debt in certain jurisdictions.

Private equity investment funds involve multiple portfolio investments, usually in several jurisdictions, and thus the definition of events of default is radically different than in a project or corporate financing. Events of default are strictly tied to the financing, itself, rather than the operations of any particular investment. Such events as attachments or nationalisations may be less significant even if leading to a write-off, where success of a fund and repayment of a loan is tied to a diverse portfolio of investments made and exited over a term of many years.

Private equity investment funds comprise not only sponsors but also multiple investors with no management role and thus security interests afforded to lenders are restricted to protect such passive investors. Security interests granted in connection with fund-level or portfolio-wide financings are not the leakage-free security package typical of project financings or even the expansive security interest characteristic of corporate financings. Rather, with intermediary vehicles and third party co-investors critical to the making of many portfolio investments, a security interest below the level of a debt-financed fund vehicle, itself, is impractical.

In many cases, practices flow from the developing to the emerging markets. With regard to the debt financing of private equity investment funds, however, it is the emerging markets that are at the forefront. ■

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CAPITAL MARKETS

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▶ THE MIGRATION OF US BUSINESSES TO AIM

London's AIM market has seen spectacular growth over the last three years, with the number of companies listed now standing at over 1700, and more money being raised on AIM than ever before. The market has matured, with average market capitalisation and deal size both increasing, reflecting a discernable shift towards quality and scale. Another marked feature of the AIM market over the last few years has been the growth in listings of international (i.e., non UK) businesses. A recent survey identified 642 AIM companies as international, either because they are incorporated outside the UK or because the majority of their business is overseas.

US companies are leading the charge, as a result of a 'push and pull' effect. As AIM has developed as a highly attractive market for smaller, growing companies, so the US capital markets have moved away from such enterprises. Increased regulation in the US, particularly the Sarbanes-Oxley Act, has compounded matters. This lack of focus within the ▶▶

US capital markets on small and mid-cap companies, the consequent inability to raise public capital effectively and economically, and the regulatory burden in the US have led a rapid increase in US company admissions to AIM.

According to a recent survey, there are now 92 US businesses on AIM, representing over 5 percent of the total market and some way ahead of the chasing pack – Australia (62), China (49) and Canada (47). In the last 12 months alone, 23 US businesses have floated on AIM and this momentum seems set to continue, with a growing pipeline of US businesses choosing AIM in preference to either a domestic floatation or further recourse to plentiful but relatively unattractive private equity.

The US capital markets and their political supporters identified this growing shift towards London some time ago and have sought to denigrate AIM as a poorly regulated, wild-west market which any discerning business should seek to avoid. This largely politically-motivated commentary, almost invariably misplaced, and much of which emerged during the course of the unsuccessful attempt by NASDAQ to acquire the London Stock Exchange, has now largely disappeared and should be set against a backdrop of the flow of US companies to London, and the increase in institutional money being invested in AIM stocks, much of which is being driven by US investors themselves.

AIM has become a market of choice for US businesses seeking growth capital. The strands which became evident a few years ago have developed into a capital markets bridge across the Atlantic which is now firmly established. AIM is, at last, a part of the US landscape. ■

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▶ 2007 US SECURITIES REFORM – TWO THUMBS UP

Responding to criticism that the US securities markets have become uncompetitive, during 2007, the SEC undertook significant reforms intended to ease the reporting and disclosure requirements for smaller public companies and to facilitate capital formation for these companies. The SEC appears to have gotten it right.

In November 2007, three of the proposed rules were adopted. The SEC has said it intends to adopt the remaining proposals by early 2008. The new rules expand the eligibility for scaled disclosure and reporting requirements to most companies with a public float of less than $75m. A new category, 'smaller reporting company,' which includes US and foreign issuers with a public float of less than $75m, may benefit from scaled disclosure requirements that have been incorporated into Regulation S-K. Regulation S-B (previously for 'small business issuers') and the S-B filing forms have been eliminated. The rules provide for an 'a la carte' approach to Regulation S-K that permits smaller public companies to select the levels of non-financial disclosure with which they will comply on an item-by-item basis. The rules were intended to eliminate the perceived 'stigma' associated with using S-B forms.

Rule 144 permits the resale of restricted securities subject to certain conditions, without registration under Section 5 of the Securities Act. Restricted securities are securities that have been acquired in transactions exempt from registration, including pre-IPO stock, stock issued in private placements, and Rule 144A securities. The new rules reduce the required Rule 144 holding period to six months for securities of public companies and to one year for securities of non-reporting issuers. In addition, the new rules ease the manner of sale restrictions and filing requirements. The amendments also eliminate the presumptive underwriter concept under Rule 145, except in the case of shell companies, for security holders that receive restricted securities as acquisition consideration.

These amendments will reduce the cost of capital in private placements by making restricted securities more liquid. The new rules are likely to change the way in which companies evaluate their financing options. For example, the liquidity discount associated with PIPE and 144A offerings may be reduced. Investors in PIPE and 144A offerings may change their views regarding registration rights in light of the shortened holding period for restricted securities. Especially in the case of 144A offerings with exchange offers, registration rights may fall away. The SEC also has proposed reducing the eligibility requirements for use of Form S-3 and Form F-3 for smaller public companies. If smaller public companies have access to shelf registration statements, issuers may instead choose to finance through registered direct offerings or opportunistic block sales or bought deals. Amended Rule 144 and the expanded availability of Form S-3 together will likely increase the value of the securities of smaller public companies as acquisition consideration. Thought leaders in the US securities industry have commented that these reforms should prove important, and only with time, will we be able to see just how important. They also express great relief that attempts to reintroduce tolling were unsuccessful. ■

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▶ CAPITAL MARKETS: FINANCING OPTIONS FOR MID- AND MICRO-CAPS

Originally the financing vehicle of the micro cap company that had a difficult time finding sources of capital, the PIPE market is coming of age with the largest growth seen in the small to midcap space with an increase year over year of approximately 43 percent. While these issuers account for only 5 percent of the total number of transactions, they account for 54 percent of the dollars raised, according to Private Raise LLC.

Since the IPO market is relatively non-existent for companies raising $100m or less, such companies are turning to the use of a reverse merger and simultaneous PIPE transaction to meet their capital needs. As the venture community finds the new issue market closed as an exit strategy for their investments, I think that they will begin to embrace the use of these alternatives as a means of providing liquidity for their funds.

The larger firms' use of 144A equity transactions and the proliferation of trading ▸▸

platforms that will provide liquidity for the qualified institutions that invest in these issues are fueling the growth for mid-cap category. As of mid November, the PORTAL Alliance was borne. It is a collaboration of the NASDAQ's PORTAL , OPUS 5 and GSTrUE, bringing together the largest brokerage firms, Citi, Goldman, Merrill Lynch, JP Morgan, Morgan Stanley, Bear Stearns, Bank of America, Deutsch Bank, Credit Suisse, UBS, Wachovia and NASDAQ. The platform is expected to be operational by first quarter 2008. I believe that the merger of all the best features from the different platforms will create a stable, liquid environment for trading in these shares.

The SEC rule changes regarding the 144 holding period decrease from one year to six months should make PIPE deals more issuer friendly, and the elimination of the tolling penalty will enable investors that wish to hedge their position the ability to do so without affecting their holding period.

There are trading platforms, such as Restricted Stock Network, that offer accredited investors the ability to bid on or offer both 144A and traditional 144 shares on a members' only trading platform, thus enabling those that wish to purchase shares of an illiquid company the ability to do so without causing dramatic moves in the security. Also, a number of new hedge funds have emerged that will purchase in and out of the money warrants as a testament to the viability of the PIPEs strategy for smaller companies. ■

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▶ SPAC IPOS IN 2008

In 1993, the first ever initial public offering for a specified purpose acquisition company (SPAC) was launched. It raised approximately $14m and it took about one year to clear the various regulatory bodies in the United States. A lot has changed in 15 years. There were 37 SPAC IPOs consummated in 2006 and 65 consummated in 2007 as of this writing. SPAC IPOs raised an aggregate of $3.4bn in 2006 and $11.4bn thus far in 2007. Almost every major investment bank has now participated in a SPAC IPO.

We believe that the SPAC IPO market will continue to be strong in 2008, but the investor base has to be broadened. Currently, almost every SPAC IPO is being sold to the same handful of institutional investors. The underwriters involved in SPAC IPOs must branch out and introduce SPACs to new institutional buyers in order for the positive SPAC IPO trend to continue.

On average, the business combinations consummated by the smaller SPACs are outperforming the larger ones, with several China-focused SPACs leading the way. For this reason, we believe there will be an abundance of smaller China (and Asia) focused SPAC IPOs launched in 2008.

We believe there will also be a handful of 'supersized' SPAC IPOs in 2008, possibly in excess of $1bn – but only if there have been some 'big wins' by some of the larger SPACs which IPO'd in 2006 and 2007 and are currently looking for targets.

Prospective targets of the larger SPACs are complaining about the 'warrant overhang' creating too much dilution. To counter the warrant overhang issue, one SPAC IPO has already been sold with units which contain only a fraction of a warrant. We believe there will be more of these fractional warrant deals in 2008, but these IPOs will be difficult to market except for 'repeat SPACmeisters' who have had tremendous success with their prior SPACs.

We believe that, in 2008, the per-share trust amount for SPACs will continue to increase closer and closer to 100 percent of the per-unit IPO price and that the typical conversion threshold will creep up to 40 percent from what used to be 20 percent and is now 30 percent.

With these caveats and potential changes, we expect the SPAC IPO marketplace to remain robust in 2008. ■

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▶ GREENSPAN REVISIONISTA

We have just been served up a book of revisionist history from Chairman Greenspan in which he attempts to duck his responsibility for the mess currently raging in the financial markets and spilling over into the economy. For the first time, despite all of the talking heads attempts to persuade the United States and the world to the contrary, we are hearing the, dreaded to some – music to others – word 'recession' freely tossed about in the financial press. As the Chinese proverb goes "be careful what you wish for because we live in interesting times".

It is interesting to note that Mr Greenspan and his successor Mr Bernanke, who drove interest rates down so low over the 2001-2006 period that the architects of securitised subprime and other questionable mortgage and lending instruments were able to run rampant and flood the market with paper which required a surreal world in which interest rates remain ridiculously low indefinitely, are at it again. The Fed's solution to emerging splits in ▸▸

the financial market fabric has been to pander to day-traders like James Cramer and market speculators who have grown fat on a seemingly endlessly rising market and return to the days of absurdly easy credit. These market players pooh-pooh the possibility of inflation and count on the God of Globalisation to rescue US investors from a serious dent in the market value of their portfolios. This is particularly reckless in light of the fact that such a large portion of the US investing is done by now aging baby boomers, while the Fed and the Treasury Department roll the dice on their retirement years.

In addition, the major money market banks are trying to move billions of dollars in debt off their balance sheets by participating in vehicles like Mr Paulson's proposed fund to support these banks and are then moving their deteriorating Structured Investment Vehicle paper into off-balance sheet vehicles funded by the very banks whose paper is being moved. The institutions are also struggling to place billions of dollars of unsyndicated debt lent to support LBO and M&A transactions over the last six to eight months. Indeed, Citibank has had to once again turn to the Middle Eastern sellers of oil, who are not only reaping the benefit of $100/barrel oil prices, but also enjoying the windfall from the United States' profligate spending spree, to help support its balance sheet with a $7.5bn loan.

This combined monetary and fiscal policy stance is designed to push the bogey of financial distress out into the future and avoid the day of reckoning which needs to, and eventually will, come. It reminds one of the comments heard from intelligent and savvy market players as the dotcom boom was starting to implode to the effect that one should expect a never ending string of 30-percent-plus up years because economic cycles were a thing of the past. They also argued that significant drops in the economy and market would be avoided by the clever manipulation of the Fed in the financial markets and continuing support from governments which would continue to cut taxes to encourage investment regardless of the underlying state of the economy.

Interestingly November and December, following the Fed's pre-emptive 50 basis point rate cut, have seen extraordinarily volatile markets around the world. The number of days in which there has been a 1 percent or greater move in either direction in worldwide markets is stunning. Volatility is always a sign of uncertainty and the underlying economy has not been robust enough to sustain the boost Mr Bernanke attempted to give it with his rate cut. Indeed, we have seen our restructuring business begin to grow substantially again in the last quarter. Even more interestingly, this growth has come from sectors unrelated to subprime lending, housing and automotive manufacturing and supply. While much of this growth has been in out-of-court work-out situations, the expansion of problems outside of the distressed subprime, housing and automotive markets suggests to us that the economy is slowing down much faster than anticipated and that the restructuring world is about to get much, much busier. Once again we would advise people to watch and try not to fight the tape. As the old Wall Street adage says: Bulls make money, Bears make money while Pigs ('nuff said). ■

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▶ SOLVING THE SUBPRIME CRISIS

Investor confidence in the structured finance markets, in particular structured investment vehicles that have invested heavily in US mortgages, has been critically shaken. Concerns of a 'debt spiral' are already on the horizon as turbulence in student loan and auto loan securitisations become apparent. Although the US Treasury has introduced a plan that would provide short term relief to subprime mortgagors by temporarily freezing adjustable rate mortgages, many investors in the investment vehicles that hold those mortgages will incur losses since the models for their investments depended upon the scheduled interest rate resets. Lost interest revenue notwithstanding, many investors are electing a 'wait and see' approach on their investment positions or the related mortgage pools with the hope that home values will stabilise and return in the next few years to levels where their principal investment is not underwater.

Unfortunately, since it is likely that most subprime mortgagors, notwithstanding the government assistance, will either not elect to sell their homes or will not be able to sell their homes without a loss given the flood of homes that will be available for sale and the lack of liquidity, there will be an inevitable reduction in home values over the next several years. While US Treasury's plan includes the possibility that state and local governments may provide refinancing to subprime mortgagors through the issuance of local government bonds, it is difficult to understand why state and local governments would want to become investors in these mortgages given the expected losses that would be sustained by many of these already cash-strapped governments.

The solution to the subprime crisis will need to come from the capital markets and it will likely come in the form of discounted sales of portfolios of loans or discounted sales of investment positions funded by equity investors comprised primarily of private investment funds that have a greater tolerance for longer term investments without the burdens of regulatory capital requirements or the requirements of marking portfolios to market. While some of these funds were formed in 2007, it is expected that many more will be formed in 2008, significantly replacing CDOs.

The challenge for these private investments funds will be convincing investors in the securitisation vehicles that a 'wait and see' approach will ultimately be more expensive than beginning the process of discounted sales of portfolios or investment positions that account for expected declines in home values which may be compounded by the debt spiral and an economic recession. Sales of asset portfolios or investment positions to the private investment funds, albeit at a discount, will help restore investor confidence by demonstrating an appetite for those assets and investments and providing a basis for trading therein. Over time, trading spreads on those assets and investments will tighten as private investments funds compete for the acquisition of those assets and investments, ultimately retarding fears of a debt spiral and a general economic recession. ■

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▶ LEADERSHIP REQUIRED FOR DIFFICULT TIMES

Scarcity of good strong leadership will drive the availability of deals to do now more than ever, and may also make the resulting deals quite difficult to do.

The repercussions of tightening liquidity, fewer covenant-based early warning signals, complex capital structures, and large lending syndicates often comprised of non traditional lenders with little workout knowledge will place a premium on the ability to manage complex proceedings efficiently. In liquidity challenged companies, victory will go to those who can work collaboratively on managing the size of the pie rather than warring over ever shrinking slices while the enterprise disappears.

The ability of debtor managements to face difficulty early and actively to involve their lenders and investors in creative solutions will be of paramount importance. Never well prepared to provide that leadership, many are less well prepared then ever, lulled by years of easy money.

Corporate boards may be better at managing Sarbanes-Oxley compliance, but not necessarily any more able to focus on strategy, preparedness for challenges, or competitive threats than they were pre SOX. When times are tough, boards often rally 'round the CEO, listening less and less to other voices, just when their independent perspective may be what a beleaguered and often paralysed enterprise needs most.

Lenders of all stripes may find themselves sitting on their hands, with no ability to act given few covenant restrictions as signs of difficulty grow ever more obvious. In face of actual covenant violation, the complexity of the capital structure will make rights and remedies tricky to enforce effectively.

The number of players involved in many loans is high, and often piece sizes are small and the objectives (and accounting and regulatory environments) of the participants vary. Identifying and responding to difficulty will be hard as many lenders have little direct knowledge of the debtor; decision-making will be easily hamstrung. These lenders individually may have no interest in anything other than current return, or in some cases outright ownership, which will create a certain brinksmanship mentality.

To top it all off, the professional restructuring community, likely beneficiaries of this confusion as more reliance may be placed on attorneys, financial advisers, and turnaround professionals, has been underutilised for years. Much of the group that pioneered turnaround management and bankruptcy counsel as respectable professions are aging or no longer practice. Some see the next wave of restructurings as a way to replenish their dwindling coffers.

Yup, leadership will be at a premium, and good leaders may be able to prevail in the midst of mediocrity. Good leaders with money and the expertise to stay a tricky course will see much opportunity. ■

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▶ A MADE IN CANADA MESS

Canada is in the midst of a crisis in its asset-based commercial paper market (ABCP). The success or failure of the restructuring efforts of a 'Pan Canadian' committee of holders of ABCP will be the big story in the Canadian financial markets for 2008.

In August 2007, $35bn of ABCP issued by financial trusts failed to roll over, leaving existing holders stuck with no immediate source of repayment. The crisis is confined to 'Third Party' ABCP, meaning ABCP issued by Trusts that were not sponsored by one of Canada's big domestic banks.

Third Party ABCP is secured by a mixture of conventional assets that had been securitised and more complex synthetic financial assets-based on CDO and CDS contracts.

In retrospect, the crisis was a predictable outcome of a flawed market. Because the underlying assets of the Trusts that issued Third Party ABCP have long maturities, funding them by short term commercial paper always exposed the investors to the risk of a decline in the market's appetite for new commercial paper. This risk was imperfectly mitigated by 'only in Canada' liquidity facilities which required liquidity providers to retire commercial paper only in the event of a 'general market disruption'. When the market for Third Party ABCP froze in August, liquidity calls were made but went unanswered.

The abrupt collapse of the Third Party ABCP market caught Canadian investors by surprise. It was highly rated by Dominion Bond Rating Service (DBRS) based partly on the perceived quality of the underlying assets. It remains to be seen when and if the value in those assets can be returned to the current holders of Third Party ABCP.

In an effort to restore stability, four large Quebec based institutions banded together. Their proposal, called the 'Montreal Accord', is really a consensual restructuring process rather than a solution in itself. Like all restructuring processes, its first phase is a standstill period during which no default rights are enforced and a more complete and long term proposal is formulated. The second phase will be an attempt to build consensus around a long term proposal which will likely involve an amendment of the terms of the existing commercial paper. The final phase will be implementation.

The original members of the Montreal Accord have been expanded through the creation of a Pan Canadian Investor Committee and the original 60 day standstill has already been extended once for another 60 days to 14 December 2007. All the while, trading in Third Party ABCP has been substantially impaired by the opaque nature of the CDO and CDS assets that secure the paper and confidentiality claims vehemently asserted by counterparties.

Solving the ABCP mess in Canada will be a great accomplishment if it can be achieved, especially in the current environment of Investor impatience and scepticism that grows day by day. Watch for fireworks in the first quarter of 2008. ■

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SECTOR ANALYSIS

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▶ TRANSACTION LANDSCAPE IN MEDIA, COMMUNICATION AND ENTERTAINMENT SECTORS REMAINS BUOYANT FOR THE RIGHT DEALS

What is particularly intriguing about the ongoing market turmoil is not necessarily the deals that are hung or postponed, but those transactions of all sizes that are still being completed and successfully syndicated in the market, some oversubscribed. A pattern is beginning to emerge.

Transactions that are sensibly structured and priced, where investor groups can clearly see a growth story in a non-cyclical industry are best placed to succeed. The media, communication and entertainment sectors, therefore, continue to appeal to the wider market. We have seen oversubscription on Melita Cable, the leading Maltese cable provider, and a strong investor response to close syndication for the Docu Group deal in Germany – both, in fact, on pre-credit crunch structures.

Based on this, we are optimistic that there will continue to be strong media industry opportunities. Now more than ever, sponsors and investor groups are really looking to invest in businesses that have strong growth prospects, where tangible improvements can be implemented to benefit the bottom line.

Lenders with strong balance sheets that are relatively free of the syndication backlog, and those with deep sector expertise to offer customers should be well positioned to succeed in today's climate and help sponsors add real value to their portfolio businesses. Financial institutions that can pass on expertise to customers will win more MLA positions, particularly for lenders where both debt and equity are provided to sponsors – insight is invaluable.

The media industry is a very broad church and includes many sub-sectors in their own right – from content, advertising and entertainment through to TV, radio and sports. It is important that sub-sector expertise is utilised to create bank-friendly structures suitable for each sector to maximise the attraction to investor groups.

While we expect to see challenging market conditions continue well into 2008, transactions that leverage important industry knowledge and expertise to create a true EBITDA growth story will be most appealing to investors. ■

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▶ TELECOMMUNICATIONS SECTOR TRENDS FOR 2008: DÉJÀ VU AND SOMETHING NEW

The telecommunications environment is problematic.

The broadband revenue dilemma. Operators face a financial conundrum. Revenues per bit for broadband with popular flat rate pricing structures are much lower than for voice and messaging services. Yet they must handle rising volumes of traffic from peer-to-peer transactions which stress capital-intensive access networks, with little or no additional revenue under flat rate pricing to justify investments in additional capacity. Disputes between operators and other service providers and users about 'fair use' policies will intensify, unless mitigated by cooperation that involves:

Sleeping with the enemy. Deployment of innovative solutions valued by customers benefits from cooperation between telecom companies and culturally very diverse organisations (e.g., Google, Microsoft, Media companies). Telecom companies that work effectively with such partners will ultimately perform better than those focused primarily on size as the best guarantor of prosperity, while confronting:

Growing anomalies in regulatory regimes. Accounting schemes that allocate costs to individual services to justify 'fair' prices for 'Significant Market Power' operators are indefensible in converged networks. The net neutrality 'debate' has failed to distinguish operators' legitimate uses of traffic management mechanisms to avoid a 'tragedy of the commons', from their potential abuses to circumvent competition law. Near-term progress towards more rational regulatory regimes is unlikely, providing job security for lawyers and lobbyists, and opportunities for innovation in exploiting inconsistencies.

Consequently the hurdles for private equity owners of telecom firms are growing. For example Italtel's stagnant revenues have been fluctuating around €540m. A profitable exit is not in sight almost seven years after a PE investment. In battling Cisco Avaya must convince business customers that its acquirers will support substantial ongoing investments in IP technology, and not just focus on restructuring to reduce costs. The investment made in BCE will only increase in value if its relative decline in the mobile market is reversed. The wireless revenues of the largest player – Rogers – have been growing at about three times BCE's rate.

Financial reengineering and cost reductions alone are insufficient. Creative renewal strategies are needed which tackle the changing face of globalisation and new interdependencies between formerly distinct market segments. Globalisation has become the 'globalisation of globalisation', expanding from its prior thrust defined primarily by Euro-American influences. New players from emerging markets are challenging the 'usual suspects', both in manufacturing (Huawei, ZTE) and in services, from the worldwide networks of Tata and Reliance Communications to well-financed regional operators based in the Middle East and Africa. Simultaneously the 'usual suspects' are targeting developing economies (Vodafone in India) to exploit substantial growth potential in basic services revenues that are stagnant or declining elsewhere. Manufacturers – notably Ericsson – are building new revenue streams in services, software, applications, and/or multimedia to secure future growth and margins despite pressure on equipment markets. Network operators are counteracting declining revenues from traditional services by active participation in the online delivery of content and advertising, and in networked business applications, including mobile. ■

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▶ AIRLINE INDUSTRY ON THE MOVE – GROWING OPPORTUNITIES FOR MERGERS AND ACQUISITIONS

With growing pressures on financial performance and continuing deregulation, new mergers and acquisitions in the airline industry are on the horizon. Major hub carriers (e.g., Air France, Lufthansa, British Airways and United) continue to drive the consolidation of the global flag carrier landscape, while the fragmented private carrier market (LCCs, charter and regional carriers) also offers room for further takeovers.

After years of strong demand and performance improvements, the industry's profitability may be threatened despite stable passenger growth; even though inventory and pricing technology will improve, only moderate increase is expected in airfares. This is driven by growing competition as capacity expansions are expected to surpass demand. Moreover, major cost items might rise over-proportionally like fuel, environmental taxes, airport fees or crew costs. Such an environment will create an additional burden on less competitive carriers, making them an attractive target for M&A activity in 2008.

Major western hub carriers will continue to drive regional consolidation in the US and Europe, where the three majors now control more than 40 percent of total seat capacity in their regions. This trend is expected to accelerate, e.g., BA has taken a closer look to bid for Iberia, and Air France/KLM has made a non-binding offer for Alitalia. Merger talk is also heating up in the US as major flag carriers recover from years of losses and Chapter 11 conditions (e.g., Delta, United, Continental, and American West).

New open sky agreements will also revoke traditional barriers to M&A. The transatlantic agreement between the US and Europe will redefine the rules of competition, allowing European and US carriers to fly to any airport on the two continents in summer 2008. Air France and Delta already have announced a JV to serve jointly all flights from London into the US as well as all non-stop flights between their hubs – aspiring to expand this JV to all transatlantic flights until 2010. Lufthansa, United, and others are also expected to combine forces in capturing market share. Meanwhile, the 10-member Association of Southeast Asian Nations is working to reach an agreement by December 2008, perhaps boosting similar moves in that region.

In Asia, international carriers are also eyeing China as a major growth opportunity. The government may retain ownership control of local carriers, but it is open to giving minority stakes to international carriers to get access to expertise and a stronger competitive position in the industry.

In the low cost and charter market, carriers have successfully penetrated the intra-European market, substantially growing passenger volumes in the last six years and anticipating future steady growth. This should drive individual carriers as well as the highly fragmented European LCC market toward consolidation. Air Berlin has already acquired DBA and LTU and, by 2009, will add Condor. As a result, it has merged short-haul LCC and charter business and expanded to long-haul markets. Such moves wet the appetites of private carriers and will likely create future consolidation opportunities.

This trend is also visible in Asia, where Hainan Air Group merged four Chinese airlines into a domestic flagship carrier. Grand China Air will cover four regions, and to capture share in the fast-growing domestic market, aspires to grow by more than 30 planes per year. ■

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▶ THE INSURANCE AND REINSURANCE CRYSTAL BALL

In order to make any prognostications about the US insurance and reinsurance world for 2008, we have to look back at what happened in 2007. If we had to choose one letter of the alphabet to identify 2007, it would have to be 'P' as we witnessed a year full of politics and proposals and as the year comes to a close, there are many possibilities. The year began with proposed settlements to Katrina-related coverage lawsuits that were rejected by courts, with political undertones as politicians pushed for legislative change on a federal level. We saw several reinsurance proposals – including the NAIC's proposed modernisation of reinsurance regulation and the Superintendent of New York's Insurance Department proposed principles-based regulation – that would reduce, or even eliminate, collateral requirements for alien reinsurers. Additionally, the proposed optional federal legislation, which would provide life and property/casualty insurers a choice of federal rather than state regulation and was originally introduced in 2006, was re-introduced in both the Senate and the House.

These proposals may turn into actuality during 2008 and 2008 might be a year of 'A' – action and accomplishment. The implementation by EU Member States before a December 2007 deadline of the EU Reinsurance Directive demonstrates the breaking down of borders in the insurance and reinsurance world on an international level and the creation of a truly global insurance and reinsurance market. The proposed changes to the US collateral rules would further break down the world's borders by ceasing to differentiate between non-US reinsurers and domestic reinsurers. Other states, including Florida, have vowed to follow the lead taken by New York and have proposed that the collateralisation rules be rewritten in an attempt to increase reinsurance capacity. Analogously, the optional federal charter legislation would create, at least in part, a unified federal insurance regulatory landscape within the United States.

Looking forward, while it is impossible to predict if 2008 will bring us another September 11 or Katrina, the market now expects D&O and E&O claims arising from the subprime mortgage crisis. Any catastrophe – whether man-made or natural – would have the effect of changing the industry focus from proactive (trying to bring about change in the industry) to reactive (how the industry responds to the losses). The one thing that is clear is that a major catastrophe within the US would have ramifications for insurers across the world. A perfect example of spreading the risk. . . ■

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