Debt Markets Update

Autumn 2010

Introduction

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Welcome to the Autumn 2010 Debt Market Update

Q3 saw the markets shrug off summer concerns about the euro-zone sovereign debt crisis and worries of a double-dip recession to record a strong quarter across many core segments of the credit market.

With global equity markets rallying and investors' thirst for yield in this low interest rate environment generating high levels of liquidity, the bond markets in particular responded with high levels of issuance and tightened pricing. But whilst markets have responded positively to the increased chances of a further round of Central Bank quantitative easing, or QE2 as it has become known, this only serves to highlight the fragility of the current global economic environment. The short-term outlook for lending generally remains positive, but there remains a risk that markets, will be subject to further volatility in response to macroeconomic developments.

The corporate loan market was lifted in Q3 by the return of large cap M&A with banks providing strong support for BHP Billiton's bid for Potash Corp through a US$45bn loan facility. This reflects a degree of stratification in the bank market, with lenders taking aggressive underwriting positions for large cap companies, being more cautiously open for business in the mid-market and with a shortage of credit in the SME space.

In the leveraged market, strong positive momentum in September augurs well for the remainder of the year. The large pipeline of deals coming to market had caused some concern amongst market participants as to whether the still-fragile European markets will cope with the level of deal flow. The successful syndication of these deals underlines the continuing recovery of the leveraged finance market. In terms of leverage, there is an increasing divergence between the larger deals, where competition from the bond market is pushing up total debt multiples in some cases to over five times, whereas in the mid market total leverage is typically up to 4.25x.

Corporate bond markets, including high yield, rebounded after the short lull in Q2 caused by the euro-zone crisis. Two thirds of activity in high yield issuance related to refinancing existing debt. Sponsors have also begun to make use of the product in LBOs because of the relative price advantage over mezzanine. Bond investors are also typically less concerned about the use of proceeds, which has enabled some dividend recap activity to occur.

While some commentators have warned of an emerging second credit bubble in bond markets, we view these fears as overdone as pricing relative to government securities remains significantly higher than pre-crisis levels. With interest rates remaining low, and the risk of a double dip recession receding, our view is that bond markets will continue to increase their overall share of financing activity.

In contrast to buoyant levels of bond issuance and the recovery in leveraged finance, other credit markets are more subdued. With the UK Government's Competitive Spending Review now upon us, we have a special focus this quarter on the market for long term Project and Infrastructure Finance. Whilst there is an undoubted long-term requirement for infrastructure projects, the current round of austerity being implemented across Europe is dampening demand for new finance in the short-term.

On the supply side, banks are concerned about the implications of Basel III, which could require them to allocate significantly more capital against long-term project finance assets, and bond investors have withdrawn from the market in the absence of credit support from monoline insurers. The recent failure to secure funding for a hospital in Bristol highlights the impact of these issues. To re-invigorate the market, we believe the public and private sectors will need to work together to come up with new ways of financing infrastructure assets and, in particular, attracting bond finance back into the sector.

If the Project Finance market is under strain, the Commercial Mortgage Backed Security ('CMBS') market remains moribund. A large portion of these CMBS structures mature between 2011-2014 and in many cases the ratio of loan to value is too high for a conventional refinancing. In some instances, existing creditors in these deals have agreed to extend their loans on the basis asset valuations will improve over time. However, half the debt which has already matured in this sector is under a standstill arrangement or in some form of workout, which serves to highlight the complexity in resolving these situations.

Despite the specific issues in these sectors, sentiment in the credit markets has generally improved over the last quarter. With Central Banks continuing to be proactive to limit the chances of a double dip recession, the short-term outlook for the availability of debt finance is positive.

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With the coalition government budget cuts spelling the death knell for programmes like Building Schools for the Future ('BSF') and the Comprehensive Spending Review likely to result in a number of other projects facing the axe, the outlook for project financings in the UK for Q4 and the first half of 2011 is a continued low level of activity. With the majority of governments around Europe facing similar challenges that pattern seems likely to be repeated across the continent, although other parts of the globe, such as the Middle East, America and emerging economies like India, offer some encouragement to lenders. Looking further ahead, the impact of Basel III still needs to be fully digested in terms of its impact on the long tenor debt commonly used in project finance.

In future, project financiers will need to be internationally mobile to sustain their orderbook whilst deal structures and approaches to market will need to be more flexible to deal with debt market capacity constraints.

Current market characteristics

Levels of activity in the infrastructure finance market in Q3 have remained low, continuing the trend of the last 12-18 months. The majority of transactions in this market are government sponsored and as such activity levels vary from country to country depending upon factors such as:

- the general financial well being of the country involved: for instance the Middle-East oil economies show higher levels of activity whereas large parts of Europe have been much quieter in relative terms; and
- the respective government response to dealing with the effects of the recession: the UK market has been very slow for the best part of a year, whereas Ireland and Spain have had to date a steady pipeline of projects keeping developers and funders active.

In the non-government sponsored arena, the main activity comes from the energy sector where developers are increasingly looking to the project finance market to help source the massive capital investment required. Investment in this area receives political priority, which helps the orderbook relative to other sectors.

In the UK, Q3 of the infrastructure finance market has been characterised by two principle developments: on the demand side, the new coalition government's budget cuts and the impending CSR report threatens the pipeline of projects; whilst on the supply side, lenders have been nervously anticipating the consequences for funding long-term project finance transactions in the new stricter regulatory regime emanating from the Basel III negotiations. Consequently, deal flow has been weak. A similar picture presents itself in the wider European market where continued concern around certain Eurozone economies and those of central and Eastern Europe has led to difficulties in getting transactions closed and a heavy reliance on the multi-lateral lenders such as EIB and EBRD.

Spotlight: Project and Infrastructure Finance (continued)

Current lending structures

Where deals are being completed, they are typically financed, on a bank debt "club" basis with typical individual commercial lender hold levels of circa £30-£50m. This means that the financing bank group is put together before financial close, rather than the deal being underwritten by one or two banks who syndicate their exposure after close (the recently closed A12 Road in Holland saw five commercial lenders fund a commercial debt requirement of circa €175m). Lender hold levels are beginning to creep up with a number of lenders intimating (if not necessarily being asked to deliver) appetite for £75-£80m ticket sizes. However, on the larger deals capacity is still an issue and so the EIB continues to be a prominent life line to the majority of projects providing much needed liquidity into the funding market.

Well structured projects continue to attract tenors of 25 years and more whilst margins have stabilised at c.175-250bps for the majority of sectors. There has been a softening in the demand for margin ratchets and cash sweeps (dedicating a percentage of surplus cashflow to accelerating loan repayments), which were a common feature of early deals following the credit crunch. Those sectors that are considered higher risk e.g. waste and volume risk transport projects are still attracting premium pricing, 275-375bps and more onerous structuring requirements in terms of cover ratios, gearing, tail periods and contractor security packages.

In an attempt to replace the capital market structures used quite frequently before the credit crunch, where a monoline agency guarantees a project bond and thereby enhances its credit rating, different financing structures are being proposed across sectors to increase funding capacity. These include entities taking a first loss exposure to improve the underlying rating of the residual bond, or acting as a facility agent for bond investors to increase their interest in the project finance sector. To date no such structure has been successfully implemented. Some success has been had in the accommodation sectors with quasi private placement type instruments which provide some of the flexibility of bank debt products combined with the long tenors of bond products at very competitive pricing. However, the deliverability of this type of product outside of straightforward, low risk sectors like Education is yet to be tested with little evidence that the providers have appetite to lend to sectors such as Defence, Roads or Waste.

Market Outlook

Aside from the austerity measures in a number of European countries impacting demand for new financing, the buoyancy of the project finance market is further challenged by the impending Basel III regulations. One potential consequence is that lenders may have to increase the proportion of long-term funding to match the long-term nature of project finance loans and derivative products on their books. The bar is also being raised on the amount of capital banks have to put aside against their assets generally. The existing Basel II regulations had already increased the amount of capital that banks need to allocate to long-term project finance assets relative to shorter-term loans. These additional measures could have a significant impact on the availability and cost of long-term project financing going forward.

Consequently, both the public and private sector will need to adapt models and structures to accommodate the new regulatory environment. Some projects may have to simply stomach increased pricing if long term debt is the only solution (although for government deals this will erode value for money relative to traditionally procured options). Others may offer the possibility of introducing shorter term tenors or re-pricing

Spotlight: Project and Infrastructure Finance (continued)

Market Outlook (continued)

options (i.e. margin ratchets with either the private or public sector carrying the risk) so as to avoid the prohibitive cost of longer term debt. It is likely we will see a increased shift to banks providing short term funding (say construction plus one or two years of operations) with a bond re-financing to follow (with government potentially taking the re-financing risk); the bond markets offer a largely untapped source of finance for infrastructure projects and crucially they can deliver very long tenors without the regulatory costs the banks will now be incurring under Basel. However, the failure to finance the recent Bristol Hospital project with an unwrapped bond demonstrated that, absent the return of the monolines, contract structures and associated risk shares may need to be re-visited in order to access this market at a value for money price.

While Basel III brings uncertainty to future pricing, current pricing in the UK market seems to have stabilised after two years of volatility, albeit with demonstrable differences across sectors. There is also greater liquidity following the return of some of the European and international banks who re-trenched to their home markets at the height of the credit crunch. Similar patterns are evident in the more stable Eurozone economies e.g. Germany and Holland but the same cannot be said for some of the Eurozone economies and certain central and eastern European economies where sovereign risk concerns are restricting liquidity and pushing up prices. Where government bond yields and sovereign CDS prices have moved up e.g. Greece, Ireland, Portugal and to a lesser extent Spain and Italy, there has been a parallel upward shift in the pricing of commercial debt for transactions in those countries as well as a number of banks exiting the market. In Poland we have seen the necessity for 100% government guarantees of debt facilities and in other countries e.g. Slovakia, the cancellation of projects altogether due to continued economic uncertainty.

Lenders are now being far more selective of the markets they will enter both in terms of geography and sector. They are looking for stable economies, predictable deal-flow pipelines, more structured repayment streams e.g. milestone payments, shorter tenors and are more inclined to follow the developers with whom they have strong relationships. These patterns seem set to continue for the foreseeable future.

Conclusion

With the clear need to invest in our transport, energy and social infrastructure, the fiscal grip that currently chokes the project pipeline will have to be loosened at some point and projects that are ‘spend to save’ in nature, i.e. that will reduce overall cost of service delivery, will still be pursued. We also expect continued investment in areas of key political and environmental focus, in particular in renewable energy schemes. Set against this, the proposed new Basel III regime, as currently drafted, is likely to act as a disincentive to the long tenor funding from banks that we have been accustomed to in the UK and European infrastructure markets.

Therefore, the public and private sectors will need to work together to come up with new ways of financing our infrastructure assets and of attracting alternative forms of finance to traditional bank debt. It is unlikely that a one-size fits all approach will be available and so some of the fundamental assumptions developed in the last two decades around which party takes which risks on projects may have run their course.

Corporate Loans: Return of large cap M&A financing shows the depth of bank liquidity

Key trends

Q3 in the Corporate loan market saw a continuation of the generally positive trends witnessed in the first half of the year. With sovereign debt problems temporarily out of the spotlight, sentiment in the loan market improved during the third quarter as M&A activity picked up and global equity markets rallied. However sovereign debt issues are never far from the surface, as can be seen by the reappearance in the news of Ireland's debt problems, and although sentiment remains volatile, the corporate loan market has demonstrated resilience this year.

The third quarter witnessed the return of the jumbo M&A loan market with the European market delivering its strongest quarter since the onset of the Financial Crisis. BHP Billiton's success in raising US$45bn in loan commitments to support it bid for Potash Corp. demonstrates the depth of the loan market and banks' willingness to use their balance sheets and provide underwritten commitments for the right deal.

Successfully syndicated underwritten transactions in the large cap arena may also lead banks to increase their underwriting activity in the mid market, an area of the market where bank underwriting remains infrequent.

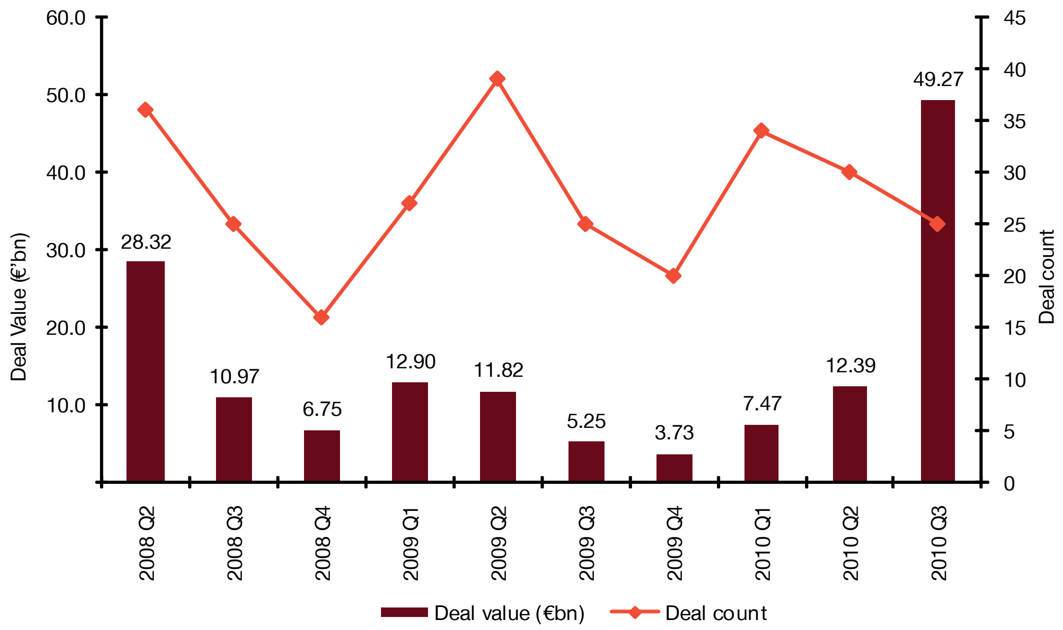
Lending Volumes

The number of investment grade financings signed between July and September has fallen by 17% against the previous quarter reflecting the traditional summer lull, however deal value tripled because of the Potash Corp bid. Mid-market M&A has been on an upward trend but has not shown the same momentum as the large cap market.

Pricing / Structure

Investment Grade loan pricing across Western Europe has tightened relative to Q2 2010 as shown in chart 2. This has been largely driven by increased bank competition in the large cap market. Our sense is that the mid-market pricing range has not changed since Q2 2010. However as banks' appetite for risk increases, transactions have featured longer maturities with five year terms increasingly common.

Chart: 1: UK volumes - Investment Grade (AAA-BBB-) Corporate Lending



Source: Dealogic LoanAnalytics

Corporate Loans: Return of large cap M&A financing shows the depth of bank liquidity (continued)

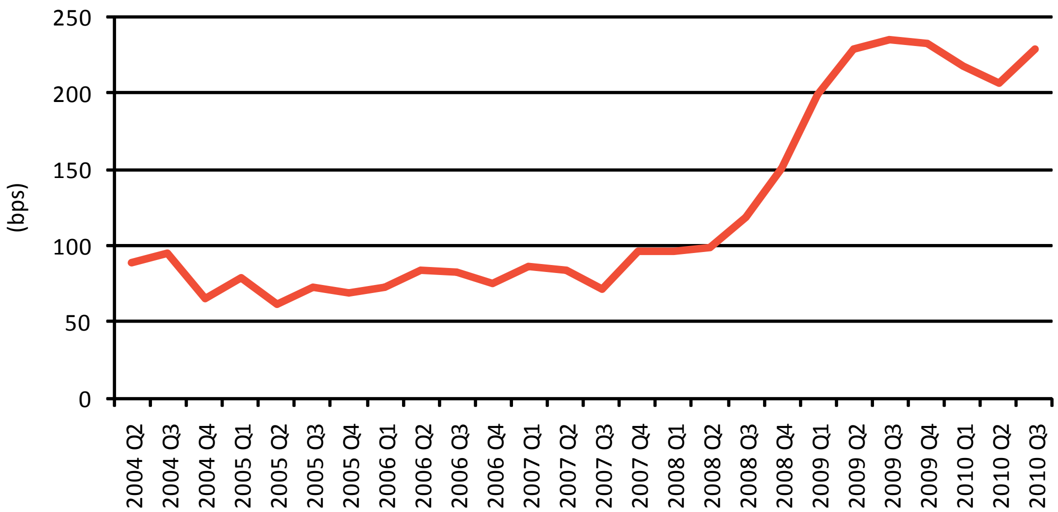
Outlook

We expect both the short and medium term outlook for loans to remain positive, as the likelihood of a double-dip recession recedes and as banks compete harder for ancillary services. As banks get more comfortable with the macroeconomic outlook we also expect to see the further re-emergence of some of the continental European banks who had exited or down-scaled their UK operations during the crisis.

The Spending Review, will also impact lenders' appetite for risk to companies significantly exposed to public sector spending reductions. However, the market will welcome the clarity around the level and the direction of public sector cuts. In addition, the upcoming VAT rise may also impact consumer focussed businesses.

The full implementation of the Basel III increased capital requirements for banks has recently been pushed back as a result of a phased implementation period running over 10 years, so it might appear that immediate concerns regarding the impact on bank lending are limited. However, we believe banks and local supervisors will want to deal with the issues much sooner than that so as to boost their market/credit credentials. We could see more capital raising to start that process as well, as banks look to keep assets relatively liquid and leverage under control. At a more detailed level, uncertainty remains around the treatment of revolving facilities with many market participants concerned that the current wording of Basel III will lead to significantly higher pricing for revolvers due to the requirement for banks to hold liquid assets against unfunded commitments. Our view is that a workable solution is likely to be found before the implementation of Basel III.

Chart: 2: European Investment Grade (AAA-BBB-) average margin over LIBOR/EURIBOR



Note: Data relates to Europe because UK sample size was small

Source: Dealogic LoanAnalytics

Client considerations

- The market remains open but banks continue to adopt a cautious approach to new lending in the mid-market
- Consequently we are seeing FDs adopt a prudent approach to refinancing typically looking out eighteen months to begin discussions
- There is also increased interest to diversify the sources of capital (e.g. bonds, private placements) as discussed further in the next section

Corporate Bonds: A resurgence of activity in September augurs well for the final quarter

Key trends

The bond market continues to show a healthy level of activity. Volumes dipped in the traditional August lull, but September has been a very active month, particularly in the high yield space with €9.8bn being priced across Western Europe. There are also a number of deals in the pipeline which augurs well for Q4 volumes.

Pricing has also fallen through the quarter: BB spreads are now back to where they were in Q1 2010 before the Eurozone crisis. Consequently, some commentators have questioned whether we are in the early stages of another credit bubble. In our view, this is overdone. Whilst coupons are on a declining trend, and there have been record volumes of high yield issuance in Europe this year, the spread above government gilts is still significantly in excess of the bull market up to 2007. For example, current BB spreads of 600bps compare to just 160bps pre-crunch.

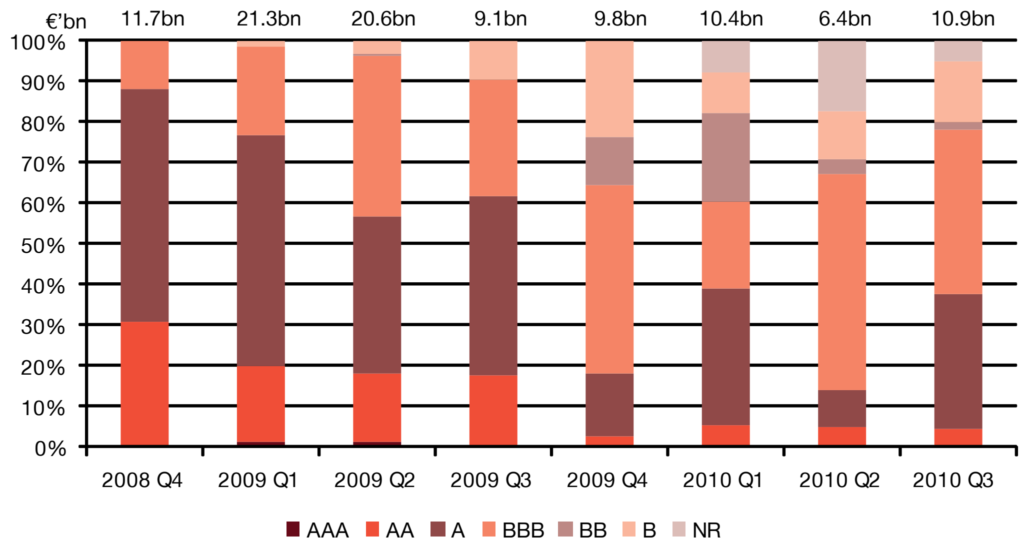
There continues to be a steady stream of new issues in the less volatile private placement market. This type of debt can be attractive to borrowers whose debt requirements fall below the minimum new issue size for a public bond (typically £150m+), but who still want to access some of the attractive properties of bonds (e.g. seven to ten year tenors). The majority of issues are rated on an equivalent basis to investment grade debt. However, with the general pressure on yields, it would not be surprising if we begin to see some higher risk borrowers tapping this market.

Introduction

Volumes

Following the fall in issuance in Q2, the UK corporate bond market in Q3 has seen a return to the levels seen at the end of 2009 and early 2010. From the supply side, the key drivers in this improvement are the passing of the immediate shock from the sovereign debt crisis in Q2 and a cautious but continued confidence in the UK economic recovery. On the demand side, there continues to be plenty of borrower appetite to tap the market to address refinancing issues particularly given the bank market has shrunk since the financial crisis.

Chart: 3: All UK bonds issued by rating (€bn)



Source: Dealogic LoanAnalytics

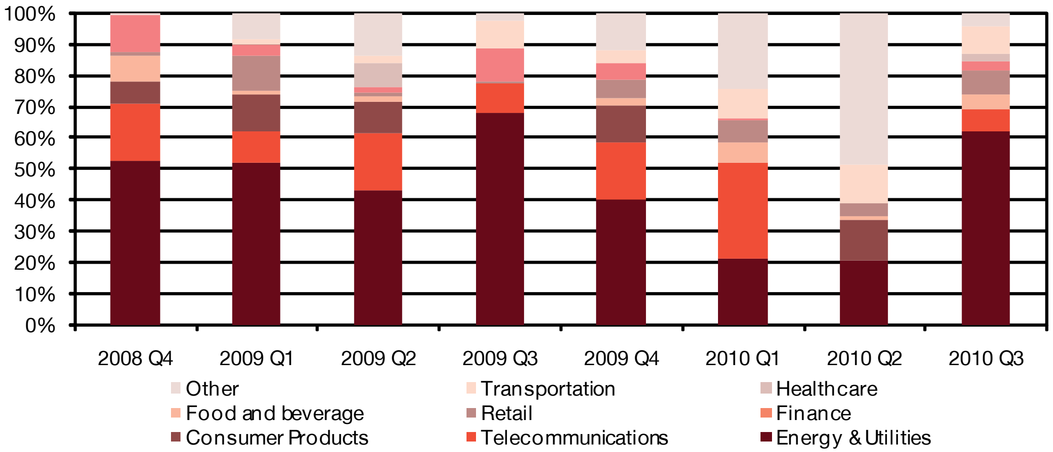
Corporate Bonds: A resurgence of activity in September augurs well for the final quarter (continued)

Volumes (continued)

Investment grade bonds were launched by Hyde Housing Association and Sanctuary Group, representing the latest in a series of major bond launches from the Housing Association sector over the last two years. Investment grade issuance, however, was once again dominated by transport and utilities companies with major bond launches from Thames Water (€663m), Scottish and Southern Energy (€1,403m), South West Water (€178m) and Great Rolling Stock Co Ltd (€955m).

The High Yield ("HY") bond sector had, until Q2 of this year, been the major success story since the credit crunch. From virtually no issuance in 2008, sub investment grade bonds represented 40% of the market by Q1 of this year. Along with the investment grade market the HY sector was cut back in the second quarter with issuance falling to €1.2bn from €3.9bn. In the last quarter this hiatus was reversed with issuers returning to the market and total deals launching of €2.1bn. We comment on more detail on the HY market later in this section.

Chart: 4: UK issues by sector



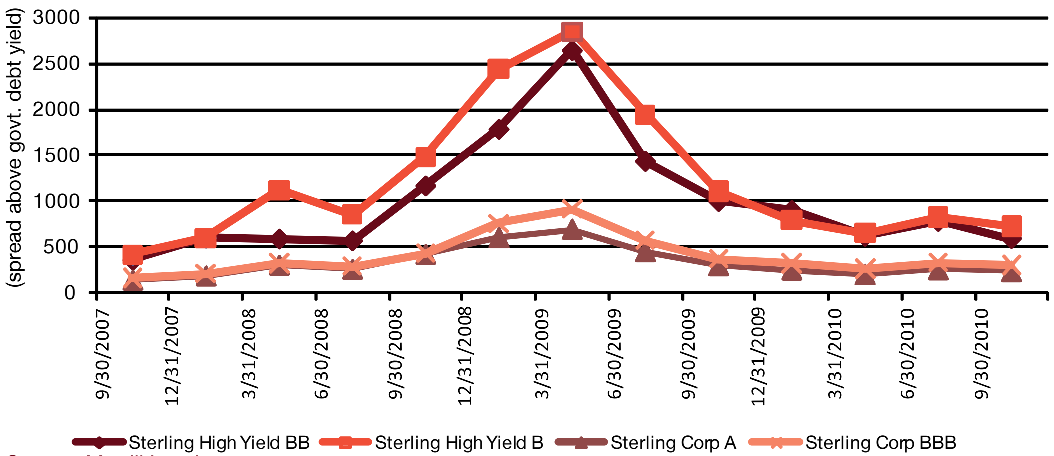
Source: Dealogic LoanAnalytics

Pricing

Prior to Q2, bond spreads had fallen for four consecutive quarters from their peak at the beginning of 2009. However, concerns over the sovereign debt crisis, the potential for a double dip recession and uncertainly over the UK General Election saw a reversal of this trend in the second quarter. Q3 saw most of this uptick reversed and average spreads are now at or below the levels seen at the onset of the credit crunch and Lehman's collapse with average A and BBB spreads of 237bp and 304bp respectively.

This improvement in pricing over the last year and a half was well illustrated by Sanctuary Group, the UK based Housing Association, who in the last quarter launched a tap to their £200m bond issued last year. The tap was priced at 100bp, the lowest pricing achieved in the sector since the credit crunch, and compares to pricing on the original bond, at the height of the credit crunch in March 2009, of 260bp.

Chart: 5: UK Corporate Bonds - spread over government debt by rating



Source: Merrill Lynch

Corporate Bonds: A resurgence of activity in September augurs well for the final quarter (continued)

High Yield

Following a short-lived scale back of issuance in Q2, there has been a resurgence in the HY market in Q3 with €2.1bn of bonds issued in the UK. In Western Europe, total volume were €9.8bn following a strong September (€4.6bn issuance).

From the supply side, the market has been driven by investors searching for yield faced by a compression in spreads across the credit spectrum. On the demand side, companies are using high yield bonds to address near term refinancing issues. Since the start of the year two thirds of issuance in Europe has been used to refinance bank debt. Thomas Cook is a good example of this trend, raising a total of £630m in bonds earlier in the year to extend its maturity profile.

Increasing amounts of leveraged loans are set to mature over the next few years. The market is anticipating that the HY sector will continue to expand to address the refinancing issues of the more robust leveraged credits. The risk remains that this notoriously fickle market shuts for a significant period of time, for example from renewed concerns in the Eurozone area, and the leveraged loan market is unable to take the strain.

HYBs have also begun to be used to support sponsor led LBOs, replacing mezzanine funding as the subordinated debt tranche e.g. Tomkins, Picard Surgeles, or even as the sole strip of debt financing (Care UK, DFS). Whilst UK Private Equity has historically only used bond finance by exception (because of strong non-call protection and the relative price of mezzanine), the increase in the cost of mezzanine post crunch, coupled with the lack of maintenance covenants in bond deals, has tipped the scales in favour of bonds.

HYB Structure

In the past, HYBs have typically been issued on an unsecured basis, however, there has been a rise in senior secured issuance as banks are increasingly willing to accept bonds that rank pari passu with senior secured debt, as long as the majority of proceeds are used to paydown their exposure. Since the start of the year senior secured bonds have accounted for 30% of all European high yield, led by key deals such as Ineos, Virgin and most recently, Continental Tyres.

For more leveraged borrowers, issuing a bond on a senior secured basis reduces execution risk because the credit rating, which is key to supporting the issue of a bond, may be notched down if the paper is structured on a subordinated basis to existing bank debt. In terms of tenor, the most common maturity is seven years. Coupons have averaged c.8% to 9% over the summer for B/B+ rated borrowers.

HYBs are an important source of liquidity in the current market, but they are only appropriate for larger borrowers. The higher arrangement costs compared to bank debt (including legal fees and the process to obtain a credit rating as well as Lead Manager fees) coupled with the need to create a liquid trading market in the bonds post issue typically require a minimum issue size of £150m for a new issuer.

Corporate Bonds: A resurgence of activity in September augurs well for the final quarter (continued)

Private placements

Issuance of Private Placements ("PP") by UK corporates saw a relatively strong Q2 with major deals from a number of issuers including Meggitt ($600m) and Capita ($375m). The activity has continued into Q3 with a number of issues coming to market. Table 1 summarises recent UK issues.

As the table indicates, PP investors are able to accept relatively small issues (e.g. Logica, Northern Foods) and will invest in a wide range of sectors. This enables corporates who are not keen to issue a bond (either because they do not want a credit rating or their debt requirements are smaller than a typical bond issue) to tap longer maturities (7-10 years).

Similar to the search for yield in the public bond market, there is talk of renewed appetite for NAIC-3 rated issues. NAIC-3 is an equivalent rating to sub investment grade and has been historically not favoured by PP investors. In 2009, there were no issues at this rating. We have yet to see a NAIC-3 rated issue (although there is evidence of weaker NAIC-2 credits coming to market), but would not be surprised if PP investors selectively dip into this band of the credit spectrum over the coming months.

The general outlook for UK PP issuance in Q4 is positive, with placements from Cookson ($150m) and MITIE ($100m) being marketed and expected to price in early Q4.

Table 1 - 2010 UK Private Placemats

Issuer	Business Description	Issue Date	Final Maturity	Principal Amount ($ mil)	Spread above US Treasuries (bps)
Britvic	Beverages	Sep-10	Sep-20	150	135
Informa Plc	Business Services	Sep-10	Sep-20	730	177-215
Whitbread Plc	Hotels and restaurants	Aug-10	Aug-18	150	200-220
JLT Group	Insurance Broking	Jul-10	Jul-20	125	265
Capita Group Plc	Support services	Jun-10	Jun-22	362	130-160
Meggitt Plc	Aerospace, defence	Jun-10	Jun-22	600	200-220
Howard de Walden Estates	Real Estate	Jun-10	Jun-22	150	170
Northern Foods Plc	Chilled and frozen food	Apr-10	Aug-18	100	200
Filtrona Plc	Manufacturing	Mar-10	Apr-20	160	225
Sage Plc	Technology	Feb-10	Jan-17	300	210
Electrocomponents Plc	Electrical	Jan-10	Jun-20	150	205

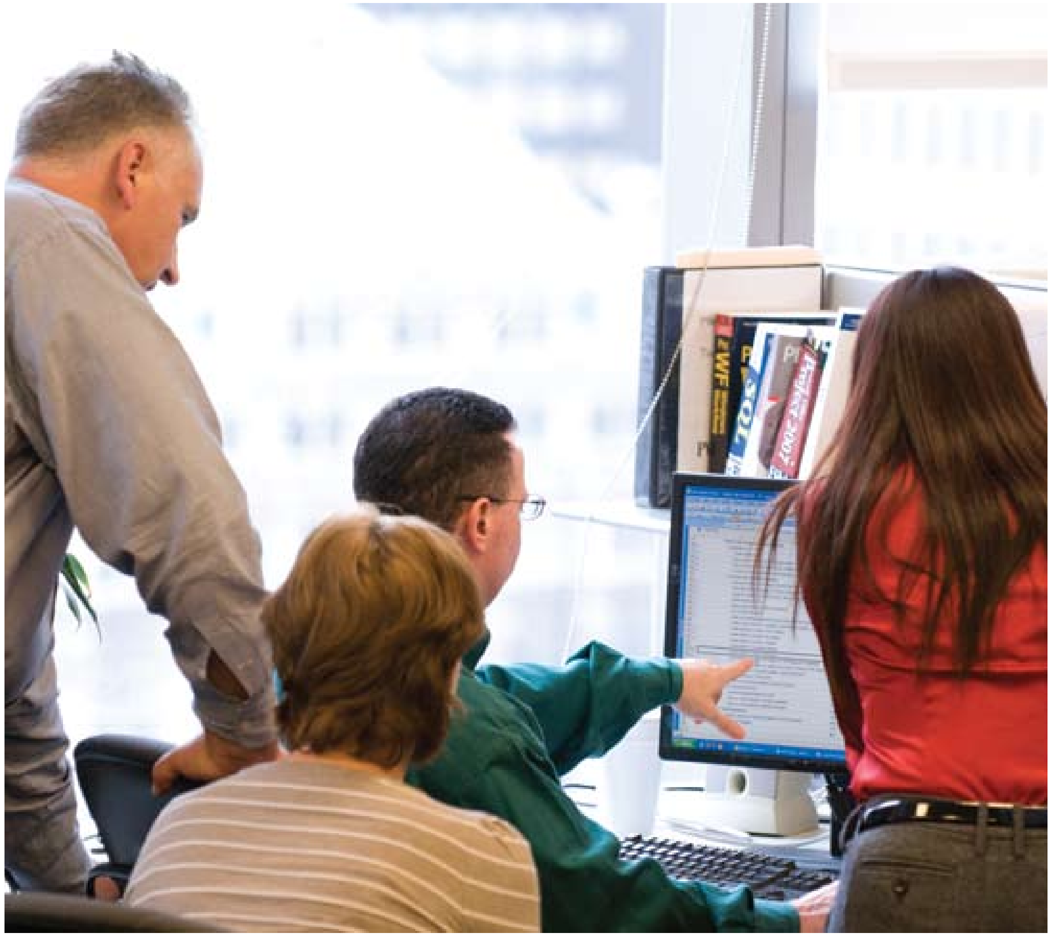
Source: Private Placement letter

Corporate Bonds: A resurgence of activity in September augurs well for the final quarter (continued)

Outlook

Despite fears for the continuation of the sovereign debt crisis in the euro-zone, particularly in Ireland and Portugal, and the risk of a double-dip recession, the longer-term trend in the UK corporate bond market remains generally positive.

The HYB market has recovered from its dip in Q2 and is being increasingly adopted by UK companies as a substitute to more traditional bank debt. Private Equity is also making use of the instrument to support buyout activity. Given the increasing number of leveraged loans which are set to fall due over the coming years (see p 20), the medium term outlook is for the market to continue to grow. Nevertheless, that expansion is likely to be punctuated by windows of activity followed by abrupt halts, as the appetite for risk waxes and wanes.



Client considerations

- The ups and downs of the capital markets aside, the bond market remains an important tool for mid size and larger borrowing to diversify sources of capital and spread the maturity profile.
- Some corporates have been using HYBs as an alternative to IPOs since they offer both a means for shareholders to realise value and raise new money without the uncertainties and dilutive impact of equity issues. It can be sensible to run IPO and HYB scenarios in parallel.
- With credit ratings a key driver to the pricing of corporate bonds and private placements, corporates should ensure they obtain the best possible rating by presenting their business to the agencies in the best possible light.
- Borrowers with a smaller level of long-term core debt should consider the private placement market to replicate some of the benefits of tapping the capital markets.
- Companies with relatively high levels of leverage, but not in financial distress, should consider the high yield market to address up coming maturities.

Asset-based lending: Sector continues to grow despite a contraction in the overall corporate debt market

Asset-based lending ("ABL") continues to be an attractive option for both borrowers and lenders. Total ABL to UK corporates in Q2 2010 increased to £14.6bn from £14.1bn in Q1 (Q3 data is not yet available), against a background of falling total net lending to UK businesses. The majority of ABL advances (circa £12bn) relates to pure invoice financing, with the remainder being more comprehensive ABL where senior debt is secured against a range of assets in a single structured finance package.

We perceive that there is strong appetite to lend in the sector with quality deals in short supply and this is driving an increase in hold sizes (up to £100m now being considered by some major ABLs).

ABL remains competitively-priced, although margins now appear to have stabilised following a gradual decline over the last year. Average margins for receivable and inventory lines now stand at 175 to 300bps over LIBOR and 275 to 350bps for term debt secured over property, plant and machinery.

Lenders continue to typically be willing to advance up to 85 per cent of receivables with lower advances for plant and machinery (up to 50–70 per cent of 120-day realisable value), property (up to 50– 70 per cent of 180-day realisable value) and inventory (up to 20-50 per cent). Fixed asset realisation values, particularly for plant and machinery but also for industrial property, have fallen significantly over the last two years. This has reduced the quantum of finance available against these assets.

Client considerations

- Despite the many attractions of ABL, potential borrowers should be aware that a marked downturn in trading can have a particularly strong impact for an ABL-backed business. It will not only suffer trading losses, but also a reduction in working capital assets to fund against
- In addition, it is critical to an ABL's funding criteria that advance rates are sufficiently conservative for it to be confident it can recover its lending in full in the event of an insolvency. Therefore, once lending requirements go beyond those advance rates, the right commercial decision for the ABL will be to recover its lending rather than to advance further funds
- This is one of the reasons why a relatively high failure rate is experienced by ABL backed businesses, although the failure rate is also significantly influenced by ABLs' willingness to back turnaround businesses, and so their clients will, on average, be higher risk. For some companies, particularly those which are asset-rich and cash flow poor, ABL may be their only remaining source of debt funding.

Leveraged Finance: Promising pick up in dealflow

Key trends

After the promising first seven months of the year, many lenders, sponsors and advisors were wondering whether this trend would be continued after the summer or if it would come to a grinding halt. Although it appeared to be a typically quiet summer period, many dealmakers were actually working in the background on a string of deals, which were all scheduled to kick off post summer.

An initial look at the first few weeks since summer seems to suggest the positive trend is continuing, with deals being completed in mid-market and larger deal sizes. Banks are getting increasingly comfortable underwriting debt packages and money continues to flow into prime rate funds and HY funds.

Private equity is continuing its foray into debt management; the most recent example is 3i's acquisition of Mizuho Investment Management. The only class of debt providers that is still struggling is the CLO funds.

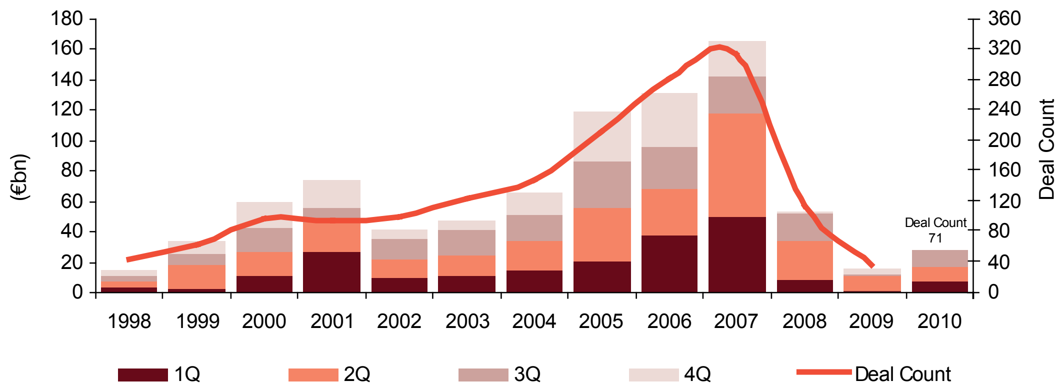
As has been the case for the past 12-18 months, debt investors (both in the loan and bond markets) continue to look for attractive, well-structured deals. However, on one point lenders appear to getting more bullish, as leverage continues to slowly creep up.

Encouraging signs

The YTD volume of new syndicated loans in Western Europe was €28bn. This is more than double levels of issuance in the same period last year (€12.4bn), but is still massively down on 2008 (€52.2bn).

The spate of buyouts in the last quarter has also increased the year-to-date proportion of loans being issued to fund buy-outs from 37% in Q2 to 51% now. This reflects improved M&A activity.

Chart 6: European leveraged loan volumes (€bn)



Source: S&P LCD

Leveraged Finance: Promising pick up in dealflow (continued)

Appetite for underwriting

Successful syndication of deals that were launched earlier in the year appears to have strengthened lenders' confidence. This is most apparent in the larger deals, where banks are stepping up to large underwriting levels. Examples are the $1.0bn term loan for Onex' and CPPIB's acquisition of Tomkins, the CHF 1.07bn term loan for CVC's acquisition of Sunrise and the €675m term loans for Lion Capital's acquisition of Picard Surgeles; each of these examples was arranged by just five banks.

Most of these larger deals are done through a combination of bank loans and bonds, therefore this willingness to underwrite partially reflects a stronger syndication appetite in both markets. Banks desire to capture lucrative bookrunner roles on bond mandates can also lead them to take a more aggressive underwriting position.

In the mid market, banks' reluctance to step into each other's deals means that these are still mostly done in the form of all-senior club deals. Recent examples are Sun Capital's acquisition of V&D and La Place (three bank club), AAC's the acquisition of NSL (three bank club) and Montagu's acquisition of Host Europe (six bank club).

Mezzanine activity

Even mezzanine is making small steps back into the market. Recent deals which have included a mezzanine tranche are the sale of RBS Worldpay to Advent and Bain and the sale of GHD to IK Investment Partners. However, the relative pricing advantage of HY bonds continues to limit the number of new mezzanine issues.

Non-bank funding

The lender landscape has changed dramatically since the pre-crunch days. The opening up of the high yield bond market for LBO transactions has clearly played a major role, but what has also helped are the newly raised credit funds by for example Alpstar, AXA and HarbourVest. In contrast, activity in the CLO market remains muted. RBS recently priced a CLO of existing loans, but no CLOs have been launched in Europe post crunch which are targeted on buying new LBO loans; despite the pickup in margins on leveraged debt, the economics for the CLO remain marginal.

Where CLOs have provided some liquidity, it has been through the re-investment of prepaid loans: JP Morgan estimate that c.€10bn of capacity has been created through this process during 2010.

In addition to the credit funds mentioned above, private equity is also playing an increasing role in the debt market. Private equity entered this market a while ago, for example through specialist debt funds such as Ares (originally owned by Apollo Management) and Sankaty (owned by Bain Capital). More recent examples include HayMarket Financial (set up in 2009 by Towerbrook Capital Partners), CVC Cordatus (set up in 2006 by CVC) and 3i's acquisition of Mizuho Investment Management (to be re-branded 3i Debt Management).

According to S&P, these European developments follow the US trend, where private equity firms' share of institutional loan allocation grew to 17% in the first half of 2010. Of course, private equity's debt management activities are not immune to the developments in the wider market, as was evidenced by Carlyle's sale of a massive €1.5bn loan portfolio, following a redemption notice by Goldman Sachs and a hedge fund.

Overall, the non-bank market for leveraged loans is still much smaller than the US S&P LCD estimate that in H1 2010, so called 'institutional' leveraged loan volume was $75bn compared to $5.7bn in Europe. Pre-crunch, the US institutional market was c.2x to 3x larger than Europe emphasising the relative pull-back in activity in Europe.

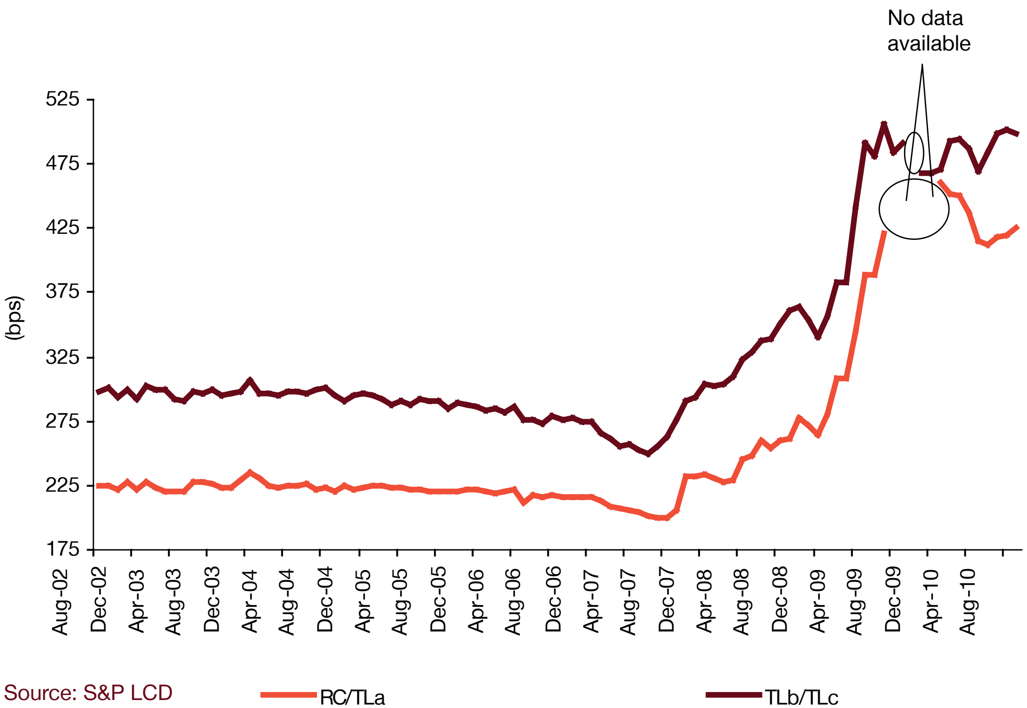
Leveraged Finance: Promising pick up in dealflow (continued)

Pricing stays level

The average margins for new European leveraged loans in Q3 was 420 bps for term A/RCF loans and 495bps on bullet tranches.

Arrangement fees remain at around four per cent on senior debt.

Chart: 7: European weighted average new issues spreads



Source: S&P LCD

Leveraged Finance: Promising pick up in dealflow (continued)

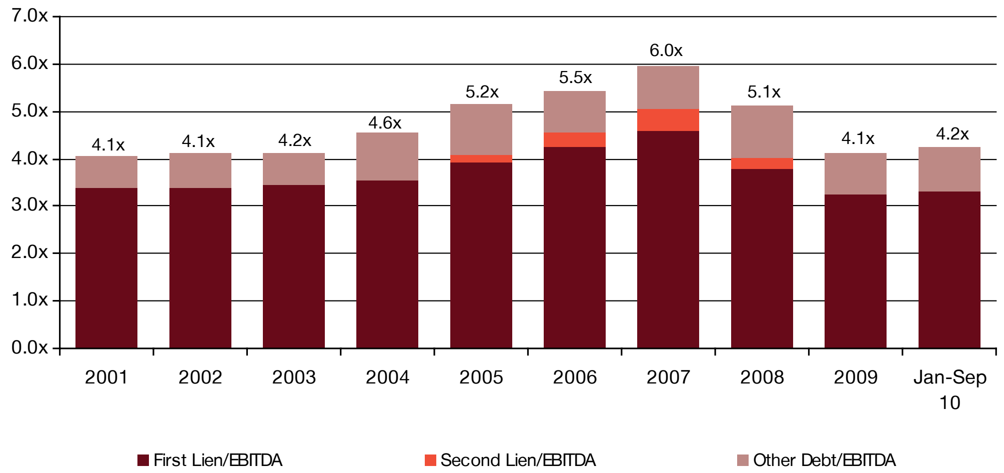
Gearing goes up

Debt multiples appear to be slowly creeping up. Average YTD debt to EBITDA multiples increased slightly in Q3 to the region of 3.3x for senior debt and 4.2x for total leverage.

The willingness to increase leverage for the right deal is apparent in some of the larger deals that were launched recently: RBS Worldpay (3.4x senior, 4.7x total), Birds Eye Iglo (3.8x senior, 5.14x total) and Picard Surgeles (3.8x senior, 5.6x total).

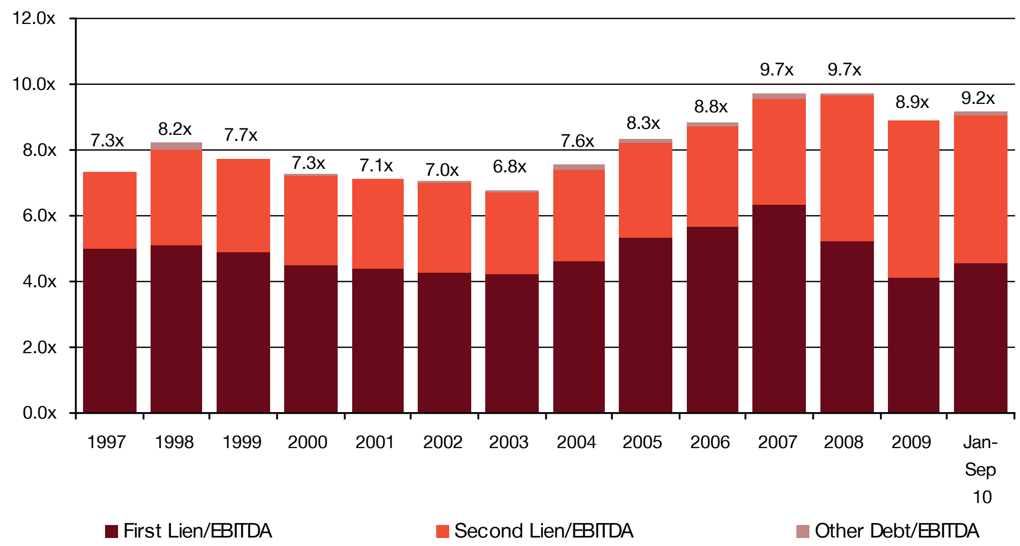
Purchase price multiples have moved in line with the increase in leverage multiples with equity contributions remaining at c.50%.

Chart 8: Annual Pro-forma Debt-EBITDA ratios of European LBOs



Source: S&P LCD

Chart 9: Sources of proceeds as a multiple of EBITDA of European LBOs



Source: S&P LCD

Leveraged Finance: Promising pick up in dealflow (continued)

Outlook

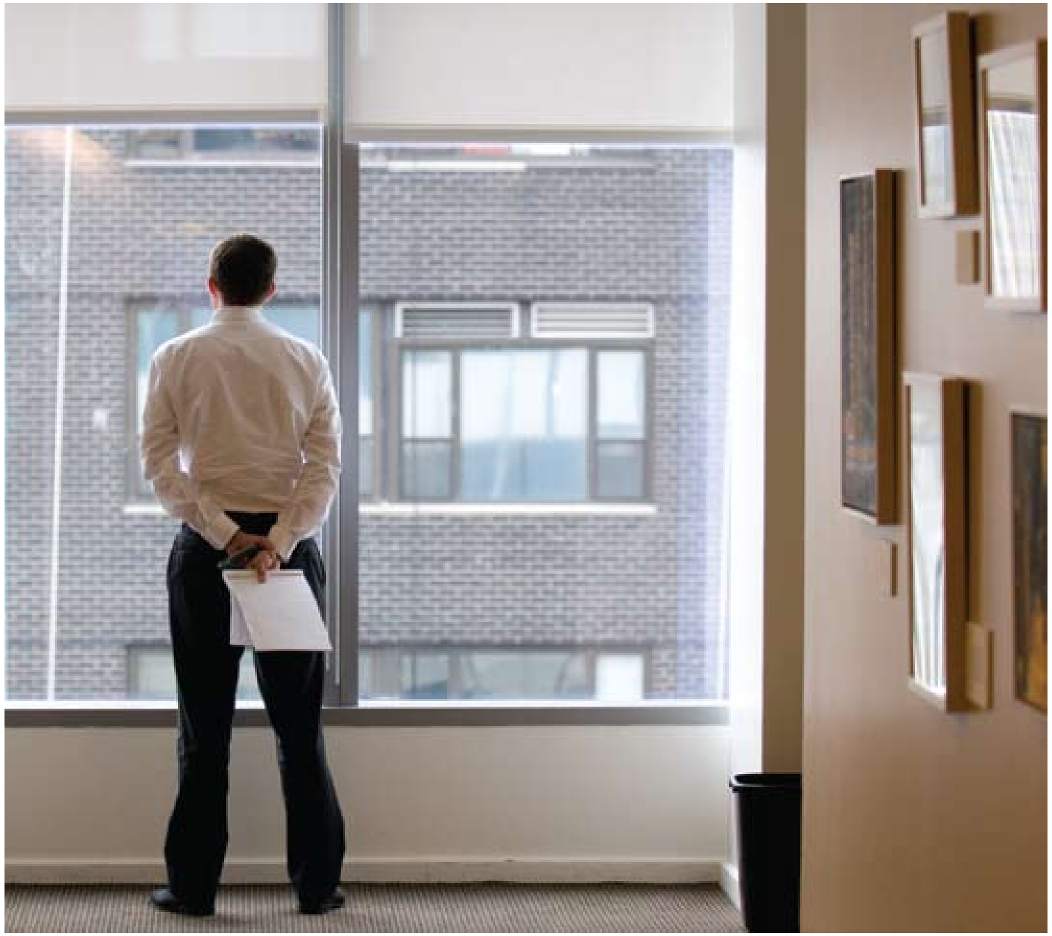
The debt market has gradually improved over the past 12-18 months. With the major investment banks having strengthened their leveraged finance teams, the first few weeks after the summer were widely seen as a decisive point: was the leveraged finance market going to truly take off or had it just been a short term run?

The answer seems to be the former. As described above, liquidity in the bank market has rebounded, supplemented by further liquidity from various credit funds. Appetite from debt investors for high yield bonds remains high and mezzanine funds have significant unspent funds.

However, as we pointed out in previous debt market updates, lenders remain selective: debt is only available to strong borrowers and facilities have to be well-structured for example, arrangers have started to include LIBOR floors on institutional loan tranches to attract funds and investors in high yield bonds require strong call protection.

Client considerations

- Given the increasing capacity and depth in the European leveraged finance market, there is scope for prospective borrowers to be more demanding, not just in terms of price but also with regard to debt multiples and tenors. A well run process will maximise available terms.
- When considering to raise new financing, borrowers should take into consideration the full range of sources available to them, which may include commercial banks, specialized debt funds, bank loan mutual funds, mezzanine funds, asset-backed loan (ABL) providers and various capital markets.



Restructuring: The default rate declines, but the upcoming maturity wall continues to cast its shadow

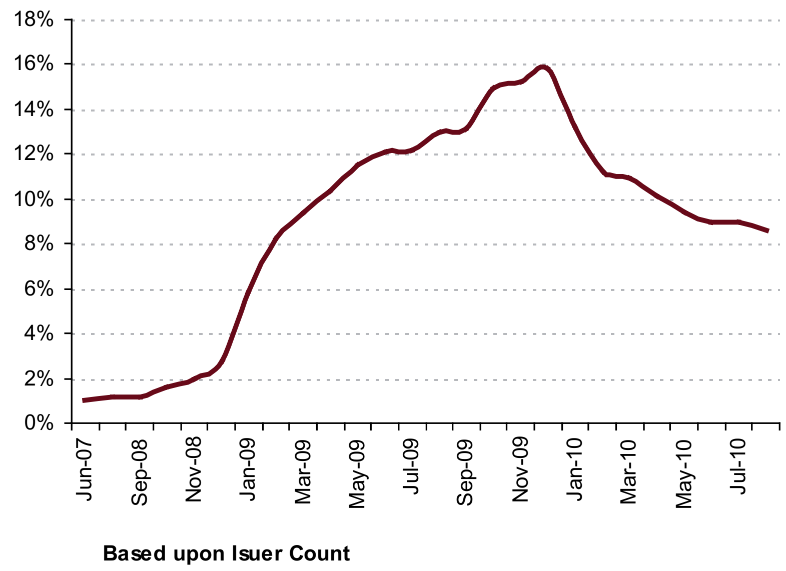
Key messages

The number of new leveraged corporate defaults in Europe has stabilised at c.5 a quarter, significantly lower than the number of companies getting into financial difficulties at the height of the recession last year.

Nevertheless, concerns over the health of a significant number of borrowers, coupled with the size of the upcoming maturity wall, which is only gradually being eroded, continue to weigh on the market. Despite a general recovery in the price of debt traded on the secondary loan market, approximately 20% of European leveraged borrowers continue to be quoted at below 80p in the £1.

Maturing loans in the Commercial Mortgage Backed Security market represent a more immediate refinancing risk. Moreover, the leverage in these structures is typically greater than would be available on commercial terms in today's environment. Indicating the difficultly borrowers face in refinancing these loans, over half that have already fallen due for repayment are in some form of standstill arrangement or in active work-out. That said, creditors have been willing in some cases to extend the maturity of their debt rather than take enforcement action, indeed a third of such loans have been resolved in this manner.

Chart 10: 12 month trailing default rate – S&P LCD leveraged loan index



Source: S&P LCD

Restructuring: The default rate declines, but the upcoming maturity wall continues to cast its shadow (continued)

Default rates

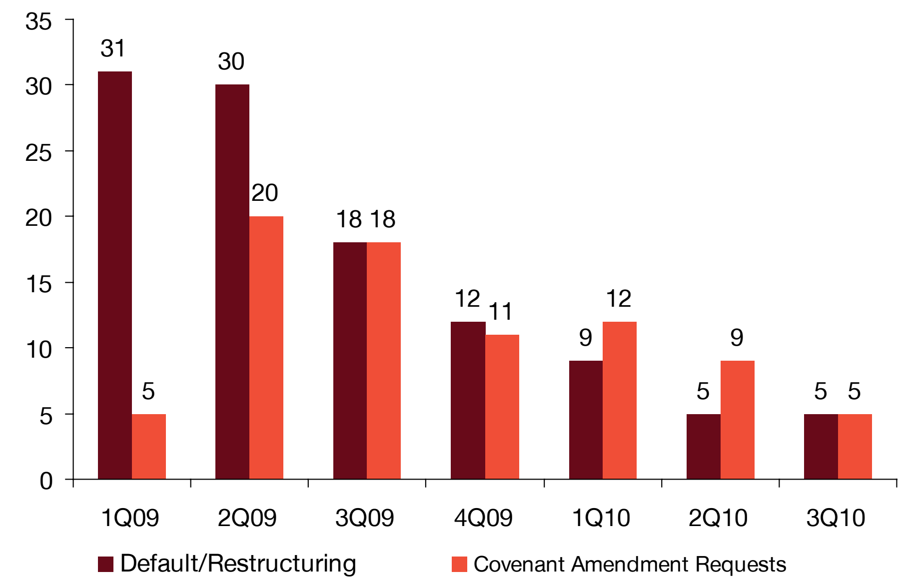
The number of European leveraged companies incurring payment defaults or entering into formal restructuring negotiations has stabilised at five deals in Q3 2010, the same number experienced in the previous quarter, resulting in the rolling 12 month default rate continuing to fall to c.8% of issues – still well above pre-recession rates.

Maturity wall

Whilst the default rate is falling, the market continues to be concerned about the quantum of leveraged loans which are set to mature over the coming years, principally from 2013 onwards.

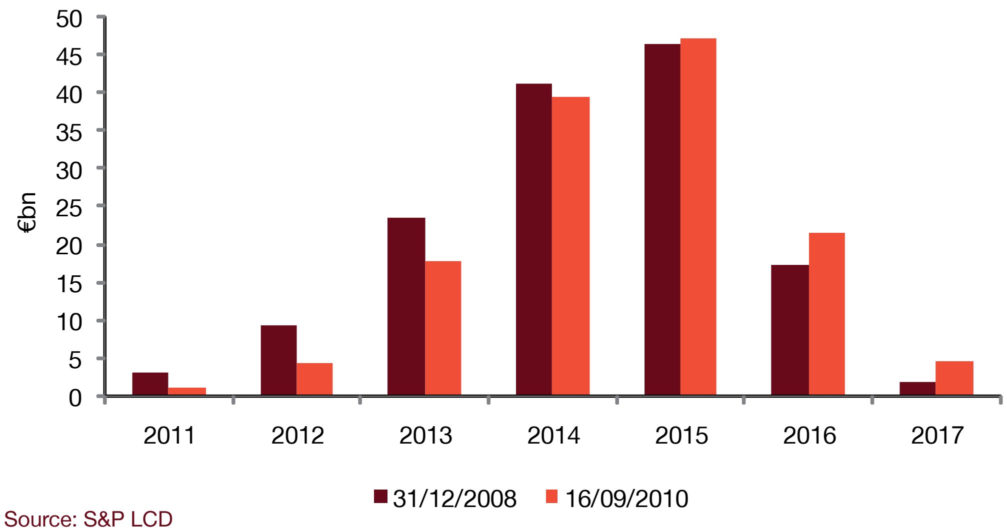
In terms of bullet facilities, while some progress has been made in tackling the relatively small amount of loans maturing in 2011/ 2012, the bulk of 2013 maturities remain untouched. Total maturities reach a peak in 2014/2015 when 64% of issuance is set to mature.

Chart 11: Number of new restructurings and covenant resets – European leveraged loans



Source: S&P LCD

Chart 12: Loan maturities - European institutional debt (€bn)



Source: S&P LCD

Restructuring: The default rate declines, but the upcoming maturity wall continues to cast its shadow (continued)

Maturity wall (continued)

Including amortising debt and revolving facilities, JP Morgan estimate that only about 20% of European leveraged loans set to mature by December 2013 have so far been refinanced, leaving a further c.€90bn to work through. This is in stark contrast to the US where outstanding leveraged loans maturing over the same period have fallen from $234bn to $138bn, principally due to much more appetite from investment funds for new paper.

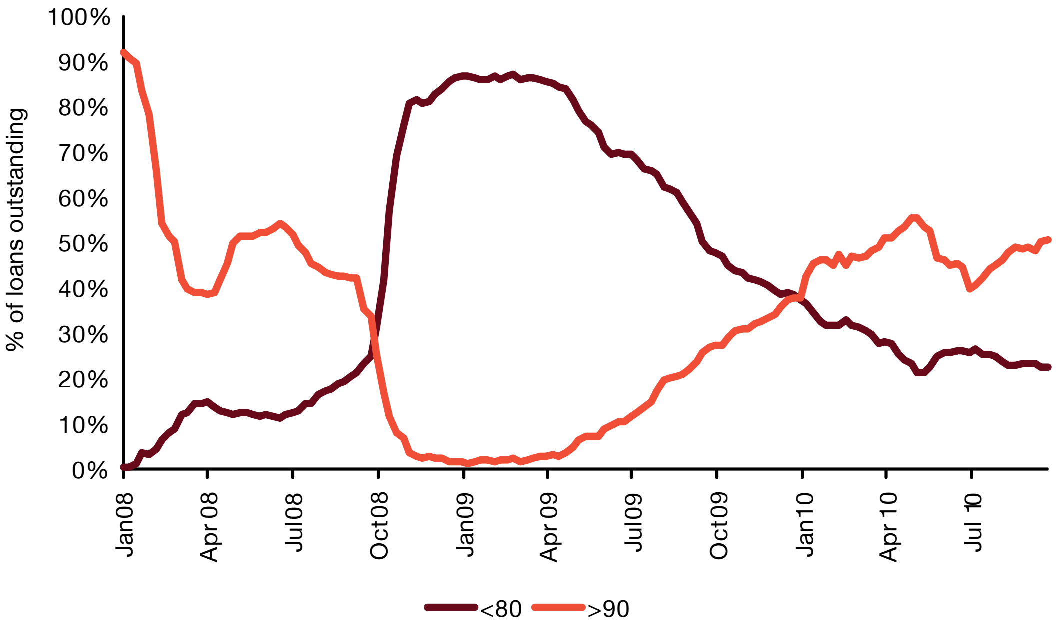
The ability to refinance this wave of maturing loans is made more challenging by the fact that the majority of CLO investment vehicles (which were a key driver of market liquidity in the boom years up to 2007) will cease to be able to reinvest their funds just as the quantum of maturing loans reaches its projected peak.

Despite these issues, we believe healthier corporates will be able to use high yield bonds and new leveraged loans to address their upcoming maturities. However, we expect there will be a significant number of companies who are forced to enter restructuring negotiations to resolve upcoming maturities.

Secondary prices

Indeed, whilst the proportion of European leveraged loans trading at over 90 in the secondary market has risen steadily over the last year, 20% of issuers continue to trade at below 80 (see Chart 12). This suggests the market continues to have concerns over the financial stability of a significant proportion of borrowers.

Chart 13: Percentage of issuers trading in different pricing bands



Source: S&P LCD, ELLI index

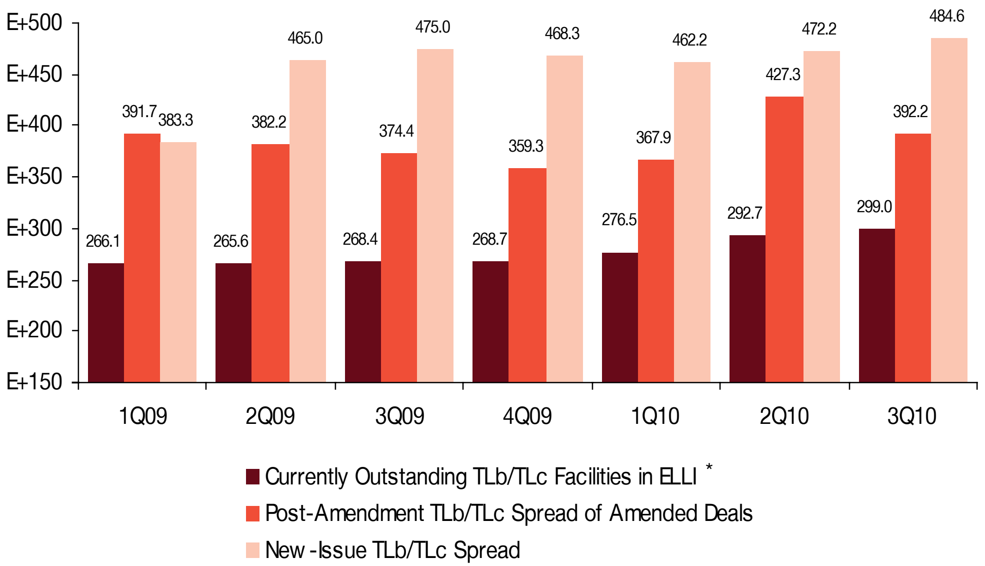
Restructuring: The default rate declines, but the upcoming maturity wall continues to cast its shadow (continued)

Pricing and covenants

Restructured facilities typically involve a c.100bps increase in margin as lenders seek to re-price the loans to their underlying risk profile, however these are still not reflective of market rates.

Typical amendment fees on recent European deals continue to range between 50bps and 100bps depending on the complexity of the ask of the lenders, and have averaged 50bps this quarter.

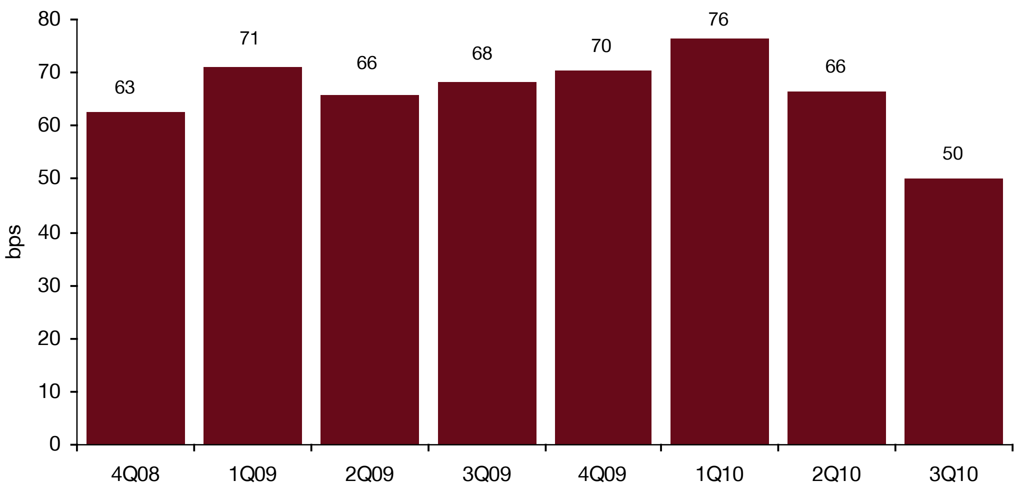
Chart 14: Average Margins on LBO facilities



* European leveraged loan index

Source: S&P LCD

Chart 15: Average amendment fee



Source: S&P LCD

Restructuring: The default rate declines, but the upcoming maturity wall continues to cast its shadow (continued)

Recently completed restructurings in Europe

The table below sets out the key terms of restructurings completed over the last few months. The terms of restructurings tend to reflect the individual circumstances of the deal (e.g. leverage, valuation, types of stakeholder, jurisdiction). However, it is apparent that in some of the more complex restructurings e.g. Gala, Almatis, Carl Zeiss Vision the equity or junior stakeholders have had to inject material amounts of new money to retain control of the business. Equally, in certain situations, where senior lenders have more confidence that their debt is ultimately covered, or they are less inclined to take control of the business, a relatively small amount of new equity can be used to retain control. This was the case in Bodybell and a number of deals we have worked on over the last twelve months.

Finally, the Panrico deal in Spain emphasises that lenders can take control in jurisdictions where there has been previously limited history of such an outcome.

Table 2: Recently completed restructuring in Western Europe

Deal	Sector	Completion date	Total cash pay debt	Leverage pre-restructuring	Net senior leverage post-restructuring	Amendment to Senior debt	Amendment to junior debt	Equity injection	Sponsor's equity holding post restructuring (%)
Carl Zeiss	Optical lenses	Oct-10	€850m	c.7x	3.0x	15% haircut on debt repaid from equity. Remaining senior debt of c.€400m paying E + 138bps/153bps. Additional €46m subordinated strip	€60m secon lien pikked at 2% increasing to 4% until 2019. 2024 maturity	€430m (€340m to repay debt) plus €150m guarantee of remaining debt	One of the two sponsors retains control
Panrico	Food manufacturing	Sep-10	€600m	c.12.0x	7.0x	New €30m super senior RCF paying E + 750bs, €350m senior tranche - E + 262bps cash + 190bps PIK and €115m PIK tranche (750bps); remainder of debt written off	Written off	None	Nil
Almatis	Aluminium producer	Sep-10	€965m	12.0x	c.6.0x	Existing senior debt repaid in full. New $565m senior loan financing paying 750bps cash + 400 bps PIK	Converted into PIK notes and 40% equity stake	$100m extra equity investment	Shareholder retains 60% stake in the company.
Bodybell	Retail	Aug-10	€255m	c.13x	c.10x	Remains whole. 50 to 75bps margin uplift	Bought back by sponsors at 80% to 90% discount	€15m	Retains dominant stake
Gala Coral	Gaming	Jun-10	€2,500m	7.5x	c.5.0x	£200m debt repayment. Margins increased by 125bps and 100bps fee	Mezzanine fully converted to equity plus £200m cash injection to repay debt	None	Nil

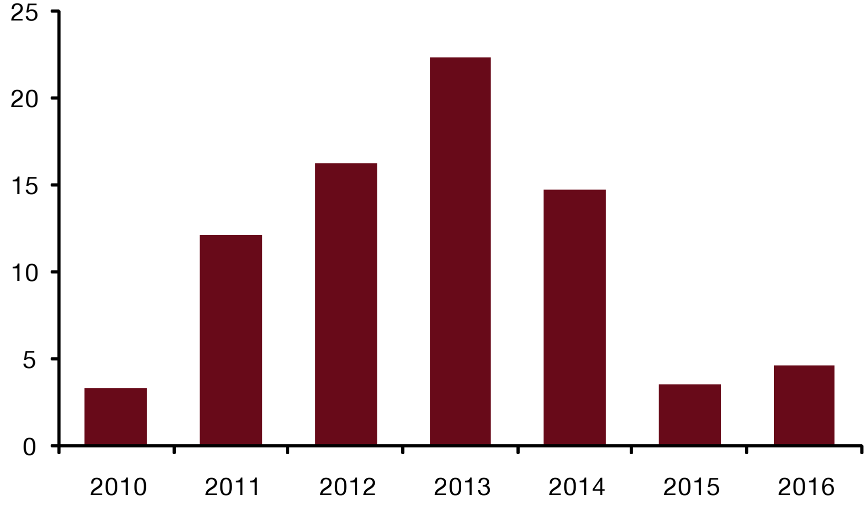
Source: Debtwire, S&P LCD, PwC analysis

Restructuring: The Commercial Mortgage Backed Securities market represents an immediate challenge

Commercial Mortgage Backed Securities ('CMBS')

During the height of the property boom in 2006 and 2007 around €115bn of European CMBS was issued. Typically, the assets in these special purpose vehicles ('SPVs') are multiple loans (secured on underlying properties), which are initially funded by the SPV issuing a number of tranches of loan notes (of different risk profiles) to external investors ('noteholders'). A servicer acts on behalf of the noteholders in their dealings with the borrower. The maturity profile of the underlying loans is concentrated around 2011-2014. In the majority of cases, ratio of the underlying loans to the value of the property assets is currently too high to allow for a conventional refinancing. The result is some form of negotiation between the borrower, its shareholder(s), the servicer and the external investors of the CMBS.

Chart 16: European CMBS Maturity Profile by Current Loan Balance (€bn)



Source: Fitch

A key factor in how the CMBS maturity wall will be worked through is that the notes in these types of structures mature a number of years after the underlying loans (the 'legal tail'). This provides the servicer with some flexibility in reacting to a maturing loan which cannot be repaid. One option is to extend the underlying loan on the basis value can be better realised in the future.

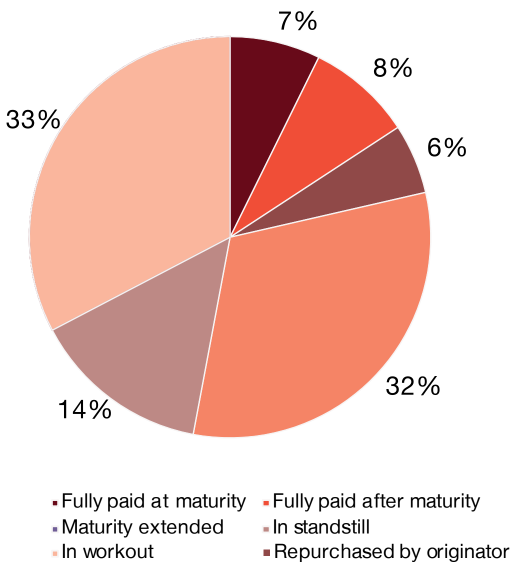
Indeed, of the value of loans that have matured to date, approximately one third has been extended thus avoiding the need to enforce security over the assets and potentially crystallise a loss. As chart 16 indicates, another 50% of matured debt is either under some form of standstill arrangement or are in a work-out process, which highlights the difficulty in refinancing these loans on a conventional basis.

Restructuring: The Commercial Mortgage Backed Securities market represents an immediate challenge (continued)

In our experience the restructuring of these maturing loans is typically complex because of the different classes of noteholder, the entry into the market of distressed debt investors and the servicer's requirement to represent all noteholders in negotiations with the borrower. Where asset quality is not expected to improve, a non-consenual solution may result.

In general, we have found that approaching the servicer prior to a payment default can improve the outcome for the borrower because it increases the amount of time in which to come to a common solution.

Chart 17 : Maturity outcomes to date



Source: Fitch

Client considerations

- Notwithstanding the decline in defaults, the approach of lenders to a covenant breach has not changed. Therefore, borrowers should continue to monitor debt covenants carefully and approach lenders significantly before any anticipated covenant breach. Although this is unlikely to achieve much of a pricing benefit, it will give lenders enough time to work through the process – which may require due diligence – prior to the breach actually occurring.
- The opening up of the high yield and leveraged loan markets offers options for mid sized to larger corporates to tackle upcoming debt maturities and avoid a complex negotiation with incumbent lenders.
- In the CMBS market, borrowers should be examining their options well before the maturity date of the loans. We recommend approaching the servicer before any potential default to give the borrower a greater degree of control over the process.

Our Debt Advisory services: How we can help you

Securing committed facilities has never been more critical

Whether you face a covenant breach, need to restructure existing facilities, have facilities due for refinancing over the next 24 months, or are considering raising debt to finance an acquisition, we have an experienced team to help you achieve your financing objectives.

We are in regular contact with 50+ banks, debt funds, asset based lenders, credit agencies and bond arrangers and can assist you in:

- maintaining control of the agenda in a debt restructuring, through our detailed knowledge of the approach lenders are taking in this rapidly changing market;
- negotiating better terms and conditions;
- advising on the appropriate debt capacity and structure in the current market in addition to the likely pricing for your transaction;
- identifying and approaching lenders which are still active in your sector;
- evaluating your business plan and testing your financial models to help to ensure they are robust; and
- credit ratings advisory / improvement of credit ratings.

Managing the process from start to end, allowing you to focus on running your business

What we do

Our Debt Advisory team provides an extensive range of services which include:

Refinancing

- Facilitate ongoing funding for the company
- Investigate alternative sources of funding
- Aim to optimise finance costs

Acquisition finance

- Increase competitive position of client by securing funding
- Assist in negotiating pricing, documentation and setting covenants

Financial/debt restructuring

- Assessment of optimal capital structure
- Restructure debt to help avoid financial distress: structure, sources and timing

Bond market advisory

- Assessment of optimal capital structure
- Restructure debt to help avoid financial distress: structure, sources and timing

Covenant negotiation

- Analysis of forecasts to support new covenant proposal
- Negotiate pricing, covenants and other terms with lenders

Staple financing

- Debt discovery exercise to confirm market appetite
- Underpins price expectations

Selected recent transactions

Region	Date	Transaction	Client	Total Debt
UK	Sep 10	Debt raising	ALE – Smarter. Safer. Stronger	€65m
UK	Aug 10	Financial restructuring	UK Hotels Group	£750m
Switzerland	Aug 10	Refinancing	ionbond	CHF180m
UK	Jul 10	Refinancing	Bernard Matthews farms	£55m
UK	Dec 09	Financial restructuring	RUSAL	$15bn
UK	Aug 09	Staple debt finance	Dalkia	£75m
Switzerland	Jun 10	Financial restructuring	oerlikon	CHF2,500m
UK/US	May 10	Financial restructuring	Public Safety Equipment	$300m
UK	Ongoing	Refinancing/public bond issue	UK consumer goods company	£1.7bn
UK	Feb 10	Debt raising	Andrew Page	£48m
UK	Aug 09	Refinancing	Northgate plc	£900m
Europe	July 09	ABL acquisition finance	CeDo	€45m
UK	Mar 10	Refinancing	safestore self storage	£350m
UK	Mar 10	Refinancing	UK property & media company	£125m
UK	Mar 10	Refinancing	MATALAN – Bank debt and 9.625% Senior notes	£525m
UK	Jan 10	8.375% Senior secured notes	Manchester United	£250m & $425m
UK	Mar 09	Refinancing	Sanctuary Housing	£200m Public Bond
UK	Aug 09	Refinancing	JP	£485m

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