

# FINANCE BRIEF

June 2008

## Life in the Post Credit Crunch World

There have been the first signs of recovery in the subinvestment grade or leveraged debt markets. However, while some of the immediate effects of the significant liquidity withdrawal are now abating, we fear that borrowers still have to deal with the medium-term effects.

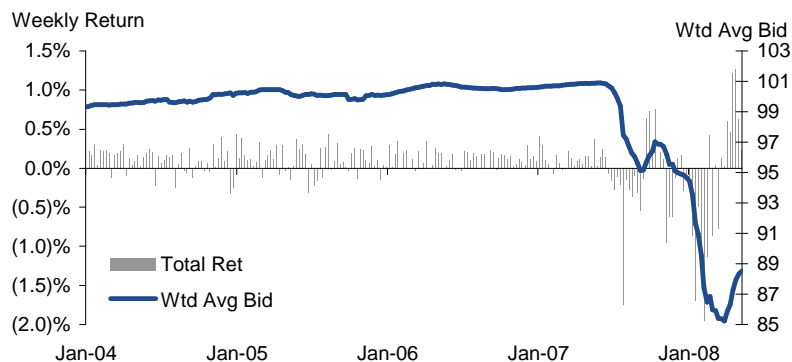
Senior debt availability for leveraged credits remains thin, costly and difficult to secure. For anything but the 'freshest, ready peeled' buyout, getting new debt is an increasingly expensive and time consuming process. Lenders are much less accommodating. Any amendments or covenant waivers are increasingly costly to negotiate with lenders often agitating for early debt repayments, forcing companies to find alternative sources of capital.

We worry that the reduction in debt liquidity has yet to feed through to credit issues. The longer-term results of the credit crunch are now colliding with slowing economies in much of Western Europe. With economic issues mounting we expect that the credit markets will take longer to recover and may well trade down further.

## The Senior Secured Debt Market

The subprime mortgage crisis in the US last summer sparked off a general sell-off in the riskier end of leveraged mortgage pools that has feed through to most other forms of risk assets over the last year. This contagion was so virulent because liquidity provision had been concentrated among so few providers – mainly the investment and loan arranging banks that lend money to investors enabling them to buy the risk assets off them in turn. As prices fell, they called for more collateral, forcing the leveraged investors to sell into a falling market, feeding the contagion.

### European Senior Secured Leveraged Loan Performance



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Source: Standard & Poor's ELLI (European Leveraged Loan Index) through 15-May-08

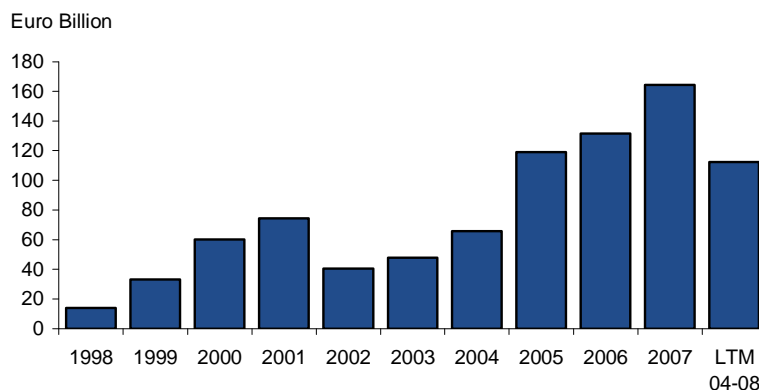
With this sudden concentrated liquidity withdrawal, the senior secured loan asset class (that has always been very stable and traded around par) suddenly lost 15 points of capital value, reporting its lowest point in early April 2008. The steady income from interest payments that funds receive (historically on average 6.6% p.a.) was not enough to offset this harsh technical reaction.

Pricing has now recovered a little but the market remains fragile. The number of buyers of new debt is sharply reduced and is now primarily focussed among traditional banks. This is an investor base that for debt issued by more risky leveraged companies is in longer-term decline due predominantly to the effects of two factors. Firstly; banks are currently still working through their own liquidity squeezes as write-downs and rebounding off-balance sheet structures require funding. Several well respected European banks consequently have to ration new lending. The second factor is a more secular retreat from leveraged corporate lending as the ever-increasing regulatory capital costs force banks to move from leveraged loan holders to arrangers. Business models are changing to a “wrap and pack” approach, where a corporate loan is originated for onward sale rather keeping it on balance sheet to anchor a business relationship.

With funding constrained, the institutional, non-bank buyer that had been growing in ascendancy has been forced into a temporary retreat - or left focussing solely on higher-yielding mezzanine or distressed opportunities,

While new capital is slowly entering the market and there is an increasing swell of positive news stories about selling of some of the over-hanging old deals (such as parts of the original £7.3 billion Alliance Boots) and larger new deals (such as the £1.14 billion placed for Biffa), liquidity still remains fragile and difficult to access. Loan underwriters remain at best very cautious in taking further warehousing risk; and at worst: blocked with unsold deals. Deals are taking time, and credit committees are much more selective as economic issues loom. Consequently in the first four months of this year, aggregate issuance of senior leveraged loans is down by 79% at €13.9 billion.

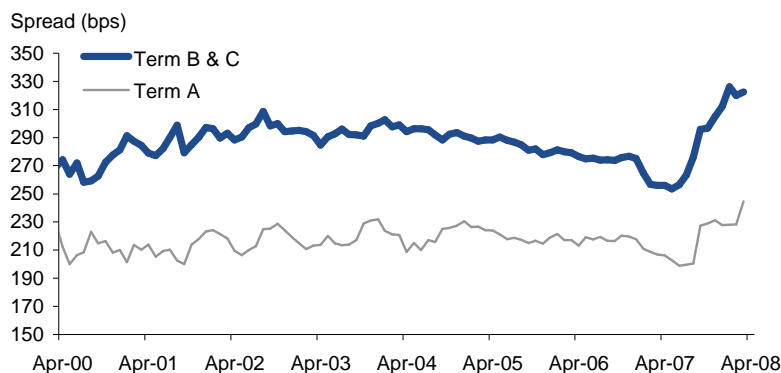
**European Senior Secured Leveraged Loan Issuance**



Source: Bankers Trust & Standard & Poor's LCD

Pricing has risen to attract the reduced liquidity, both in terms of absolute margins and in terms of risk-adjusted return – new deals now are being structured with lower quantum of debt. Standard new deal senior secured pricing is now L+275/350/400 for seven to nine year debt up from L+200-225/275/325 before the credit crunch. For amended, tricky or smaller deals we have seen pricing widen out further.

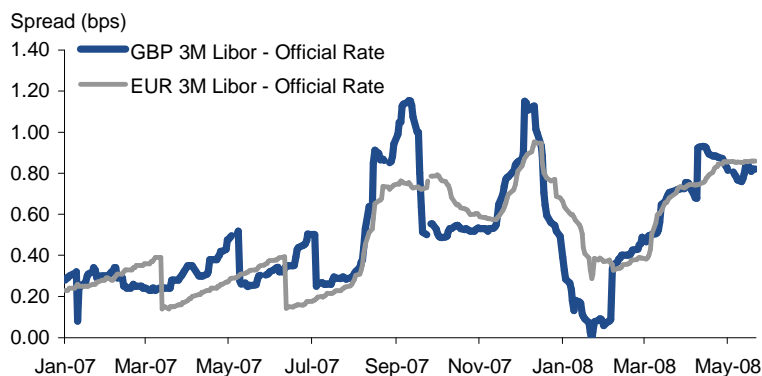
**Interest Margin over Libor for Senior Secured Leveraged Loans**



Source: 3 month rolling average of Standard & Poor's LCD deal survey

In addition to the widening lending spread, companies are facing a hidden increase in borrowing costs: the differential of the pricing base of Libor to official base rates has risen by a factor of around three to four times. Libor (London Interbank Offered Rate) reflects the actual rate at which banks borrow money from each other and is used as a lending benchmark by almost all loan agreements. While also an expression of near-term interest rate expectations, the current fragility in the financial system and squeezed bank liquidity has increased the spread of Libor against the official rates from (typically) 20-30 basis points to (currently) 80-90 basis points, with greater spikes around quarter and financial year ends.

**Differential of 3 Month Libor to Official Rates**



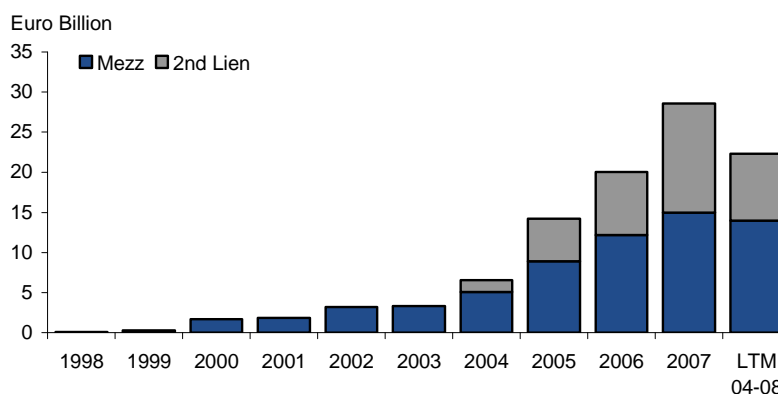
Source: British Bankers Association, ECB and Bank of England

## Mezzanine Market has been less Affected

In contrast to the senior, first-ranked or lien market, the junior second-ranked or subordinated (mezzanine) market has proven much more resilient. With a dedicated investor base that generally has not used much leverage, this market has not faced the same liquidity unwind. Indeed, several mezzanine investors have been successfully collecting new money to expand their lending.

In terms of aggregate reported issuance, volumes are similarly depressed at 74% down for the first four months of 2008 at only €2.3 billion. The cheaper form of mezzanine (so called second-lien debt) that was traditionally sold to the more leveraged institutional investors has virtually disappeared, with only one €45 million issue reported so far in 2008.

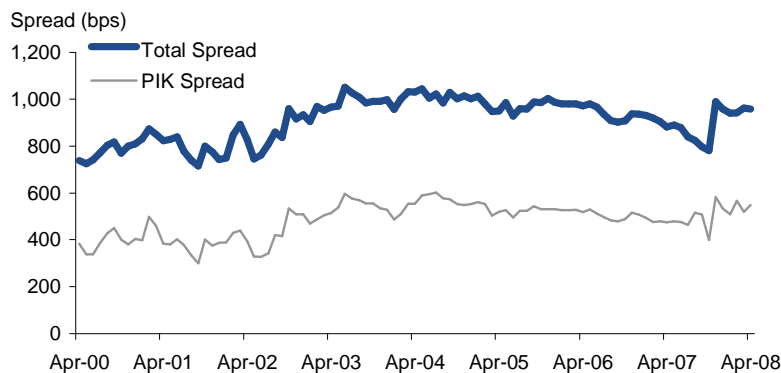
### European Junior or Mezzanine Loan Issuance



Source: Bankers Trust & Standard & Poor's LCD issuance data

The aggregate statistics mask the increasing activity these funds report, from providing new debt in stressed situations to buying up secondary positions. We have seen several funds currently very busy. Mezzanine is being used in 71% of new LBO deals this year. Risk adjusted pricing has risen in line with the increase in senior pricing.

### Interest Margin over Euibor/Libor for Subordinated Mezzanine Loans



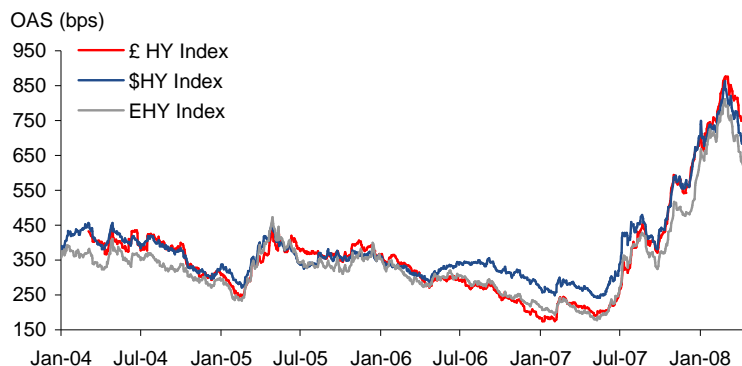
Source: 3 month rolling average of Standard & Poor's LCD deal survey through Apr-08

We have noticed an increasing differentiation in pricing between new LBO deals, and amended or rescue corporate lending. The new deal survey from Standard & Poors' LCD service reports average mezzanine pricing at L+940.5 for Apr-08 on a rolling three month basis. For smaller, new LBOs with mezzanine tranches up to €50m, we have seen pricing of between L+10-11 (with occasional warrants), and for rescue or de-leveraging financing (where mezzanine is being raised to repay senior banks) we have seen pricing at L+10-12 plus warrants.

## European High Yield Market Remains Closed

Traditionally, the European high yield market was used to place subordinated debt tranches over €300-500m, below that mezzanine would generally be used. Alternatively, the high yield market was used either for structures with longer no-call periods, and/or where a brand name with consumer recognition could be used to arbitrage the cost of credit provided by the mezzanine market.

### \$, € & £ High Yield Indexes (Spreads over Government Bonds)



Source: Merrill Lynch

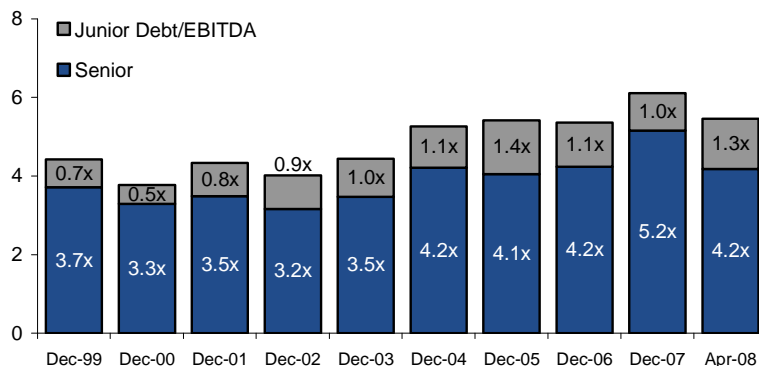
While prices have now currently stopped falling in line with the other leveraged credit markets, the European high yield market remains essentially shut. Some issuance has been sold in USD, but the last European deal (Intergen) was sold into the market back in July 2007. There is currently an active debate between investment banks and investors to what extent this market can open up in the near-term. Our conversations with traditional high yield accounts indicate a remaining hesitance and fear of ongoing market fragility. With the exception of one recent large deal, we continue to see structures (which in the past were designed as high yield bonds) either being repackaged into the mezzanine market; or for higher quality deals, sold as private placements to some select accounts.

## Effect on Valuations

Leveraged transactions are now being more conservatively structured. Average total leverage ratios to earnings have already come down from their peak at 6.6x EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) reached in August 2007 by a full multiple of EBITDA. Senior debt leverage is now just

over 4.0x EBITDA for larger deals and much closer to 3.0x EBITDA for smaller deals.

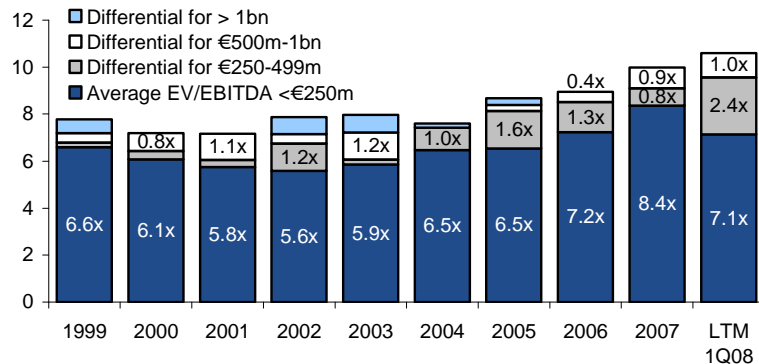
**Average Net Debt Leverage of New Deals**



Source: 3 month rolling average of Standard & Poor's LCD deal survey through Apr-08

So far we have seen more of an effect in lower volumes of deals than in the values themselves. Except for smaller deals, the lower leverage ratios have yet to feed through to lower corporate values, as private equity sponsors are often filling the gap with additional equity. Indeed, valuations of large LBOs have risen to multiples of 11x EBITDA in April 2008 with five out of the last fifteen deals even reaching multiples of over 12x EBITDA.

**LBO Enterprise Value/EBITDA Multiples**



Source: Standard & Poor's LCD deal survey for LBO multiples and deal numbers

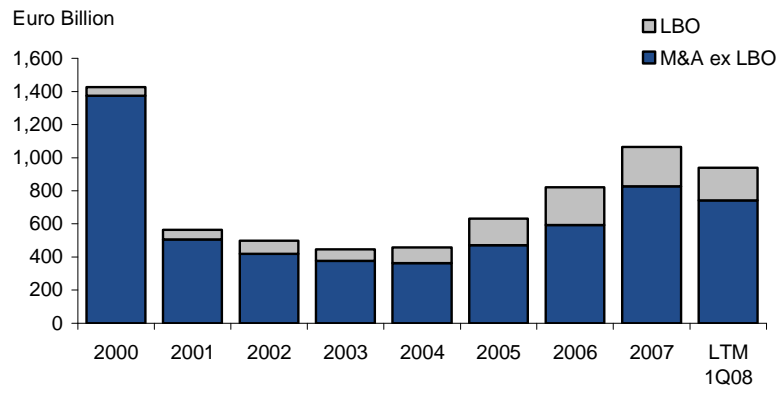
We see this as a function of the unprecedented unspent firepower remaining with private equity sponsors who are putting more equity into deals to make up the difference. The average equity component in a typical buyout has now risen from the low 30%'s to stand at 45%, with five out of the last fifteen deals over 50%.

Over time we expect that the more restrictive debt markets and lower volumes will feed into lower corporate valuations, especially for companies in industries that face any perceived credit issues and uncertainties. Currently, the market is being very careful to evaluate credits that are exposed to energy or commodity prices, localised construction, consumer expenditure or those who have an ongoing capital need to build-out their business models. The latter will

increasingly face greater difficulties in attracting the required funding, something we expect to further affect highly leveraged infrastructure credits in particular.

**M&A and LBO Volumes**

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Source: Merger Market

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## Managing in the Current Environment

Borrowers are having to manage their lending relationships carefully as several of their funders are liquidity constrained themselves. We have seen several debt investors pull back. Among non-bank funds several are retreating from lower priced senior corporate debt, as their own access to funding is constrained. Several US funds have retreated back to the US market where they see better relative value; and there are several European banks with strained balance sheets that are also pulling back from leveraged corporate lending.

One area which is causing borrowers much greater problems is amendments to their loan agreements. The costs of covenant waivers has risen from around 35 basis points to a starting benchmark of 50 basis points and upwards. If longer-term relief is sought, debt needs to be prepaid through new funding that is subordinate to the senior first-lien debt.

### Examples of Recent Covenant Waivers

	<b>Gala Coral Group Gaming &amp; Gambling Oct-05 Leveraged Acq.</b>	<b>Sanitec Bathroom fittings Apr-05 Secondary LBO</b>	<b>Mach Mobile Telco Services 2005 LBO, Refi May-07</b>
Equity Injection	£125m	€70m inject.+ €15m g'tee <sup>1</sup>	0
Other funding			
% of Total Financing	4.8%	8.3%	0.0%
Senior Prepayment	£83m	€54m	
% of Net Senior Debt	3.6%	5.2%	0.0%
Multiple of EBITDA	0.2x	0.4x	0.0x
<u>Resultant Leverage</u>			
Net Senior Leverage	5.4x	na	na
Net Senior & 2nd Lien Lev.	5.8x	5.1x	na
Net Total Lev. through Mezz	7.2x	na	na
<u>Resultant Snr Covenant Headroom</u>			
Year 1	15.5%	15.0% <sup>2</sup>	2Q08 +12.0% <sup>3</sup>
Year 2	17.5%	15.0% <sup>2</sup>	2Q09 +12.0% <sup>3</sup>
Year 3	20.9%		
<u>Waiver Cost</u>			
Consent Fee	0.50%	0.25%	0.50%
Snr Term A Margin Step-up	0.50%	0.25%	0.25%
Snr Term B Margin Step-up	0.50%	0.50%	0.25%
Snr Term C Margin Step-up	0.50%	0.50%	0.25%
2nd L/Mezz Margin Step-up	0.75%	4.00% PIK	0.50%
<u>Waiver Approval Status</u>			
Required Approval Threshold	66.6%	Interim (1Q08) 66.6%	assumed 66.6%
Reported Approval Rate	75.0%	passed	awaited by 28-May-08
		Full (2Q08-FY10) 66.6%	
		passed 17-May-08	

1. Further equity on call until 2014 callable on payment default, covenant breach or significant reduction in headroom or liquidity
2. Reduced from original ask of 17-18%
3. Current headroom unknown, waiver seeks additional 12% headroom for 12 months only

Source: Company announcements, news reports and Augusta

The examples above are benchmarks for large and popular LBOs. For smaller or more closely held deals, we have seen pricing

considerably wider conditional to the perceived credit quality (post covenant reset) and the negotiation leverage of the current lenders.

The need to prepay banks' debt and reduce senior leverage is already causing a rise in rescue equity issues in the UK where a greater proportion of companies are public than in Continental European markets. There we expect to see greater use of private equity to de-leverage senior bank structures.

In conclusion, we expect the liquidity constraints currently faced by sub-investment grade lenders to continue, and therefore for debt provision to remain significantly constrained. Borrowers need to be attuned to this more hesitant lending environment. Any amendments of existing loan agreement or requests for additional funds will require significant concessions, and borrowers should protect themselves by exploring alternative funding sources.

## Recent Examples of Public Equity Rescue Funding

### Recent Rescue Equity Funding in the UK Market

Date	Company	Amount (£ Million)	Type	Reason	Discount from			% of Mkt Cap*
					1 Month	1 Week	1 Day	
<u>Non-Financials</u>								
20-May-08	Imperial Tobacco	4,900.0	Rights issue	Repay part of the debt following a large acquisition last year	41.7%	41.0%	43.7%	27.7%
16-Apr-08	Imperial Energy	306.7	Rights issue	Pay for development of oilfields and pay off debt	56.2%	40.5%	41.5%	59.1%
14-May-08	FirstGroup	236.0	Accelerated Bookbuild	Strengthen balance sheet ahead of refinancing its debt	2.0%	7.4%	9.8%	9.1%
14-May-08	Johnston Press	212.0	Rights issue	Pay down debt	62.5%	59.4%	61.0%	54.2%
13-May-08	G4S	281.9	Accelerated Bookbuild	Reduce debt & provide funds for bolt-on acquisitions	0.9%	4.2%	7.5%	9.3%
03-Apr-08	Afren	118.8	Placement	Fund expansion of drilling wells in Nigeria	(1.8)%	(10.1)%	1.4%	39.5%
17-Apr-08	Babcock & Brown	84.0	Placement	Strengthen balance sheet	6.1%	11.9%	9.1%	25.5%
20-Apr-08	Payzone	27.5	Placement	Strengthen balance sheet, part of a combined finance raise	71.4%	54.5%	58.1%	19.0%
09-Apr-08	D1 Oils	16.1	Placement	fund restructuring (exit UK biofuels refining)	59.7%	40.8%	33.8%	69.2%
<u>Financials</u>								
22-Apr-08	Royal Bank of Scotland	12,000.0	Rights issue	Strengthen balance sheet	37.7%	43.1%	46.3%	33.1%
29-Apr-08	HBOS	4,000.0	Rights issue	Strengthen balance sheet	49.1%	49.1%	44.5%	21.5%
14-May-08	Bradford & Bingley	300.0	Rights issue	Strengthen balance sheet	50.5%	52.1%	48.3%	30.2%
11-Jan-08	Paragon	287.0	Rights issue	Repay working capital line that banks are refusing to extend	93.0%	92.6%	90.2%	245.3%
23-Apr-08	Cattles	200.0	Rights issue	Strengthen balance sheet	40.7%	43.1%	41.7%	25.7%

\* Proportion of market capitalisation one day before announcement

Source: Company announcements, Thomson IFR, Stock Exchange, press reports and Augusta & Co analysis

## Recent Examples of Public Convertible Equity Rescue Funding

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### Recent Rescue Convertible Equity Funding in the UK Market

Date	Company	Amount (£ Million)	Type	Reason	Conv. Premium	Maturity	Coupon	Redempt. Premium	Share P Reaction~	% Equity Cap.*
<u>Non-Financials</u>										
22-May-08	Inspired Gaming	40.0	Redeemable Convert. Perf.	Fund op. restructuring & growth	2.6%	5Y	7.0% PIK	50.0%	(5.0)%	68.7%
20-May-08	Payzone	4.4	Redeemable Convert. Perf.	Strengthen b/s	25.0%	10Y	7.0% PIK	6.0%	(8.0)%	2.0%

~ price reaction on the day of announcement \* Proportion of market capitalisation one day before announcement

Source: Company announcements, Thomson IFR, Stock Exchange, press reports and Augusta & Co analysis

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