The Absolute Return Letter

December 2006

Summary

Private equity is on a roll. November has seen unprecedented activity levels in the buyout market and in the first article we take a closer look at the reasons behind this. In doing so we seek to explain what the implications are for financial markets. In short, global equity markets should continue to benefit from the support the buyouts provide. High yields bonds, however, provide a very different story and we warn against loading up on this asset class.

In our second article we look at what it really means when countries such as China tie their currency to the US dollar. The implications are numerous - and they are not all bad - but, at the end of the day, the world becomes a less balanced place.

We would like to extend our very best wishes for 2007. The Absolute Return Letter will take a break for Christmas and New Year, but we will return on the 1st February.

Trash the Cash

Not so long ago a Swedish pension fund manager, who shall remain unnamed in order to protect his good name and reputation, stated publicly that *"he was never going to invest in another hedge fund. Returns were simply not attractive enough. Going forward, he would concentrate his alternative investment allocations on private equity."* Amen.

Earlier this year, the annual Cap Gemini World Wealth Report confirmed that the average high net worth investor harbours similar views. Allocations to hedge funds amongst private investors are dwindling whereas private equity allocations are on the rise all over the world.

Now, with the risk of stepping on the toes of one or two of our clients, let's remind ourselves what we learned from the previous private equity cycle which came to an abrupt end in 2001-02. We learned that all the sales talk about private equity funds providing non-correlated returns was mumbo jumbo. Contrary to what we had been told, private equity behaved no differently from any high-beta (i.e. highly volatile) listed stock.

But, most importantly, we learned that the best time to invest in private equity is when the industry cannot raise money even if their lives depended on it. And the worst time to invest is when the industry is bursting with cash. Such as now.

The last couple of weeks have seen unprecedented activity in the private equity arena with some of the largest players keen to dispense of vast sums of money before the end of the year when they next have to report to their investors. In the world I was brought up in, we had a word for this sort of behaviour. We called it *window dressing*.

Anyway, the current wave of buyouts distinguishes itself from the previous one in several ways. First and foremost, the momentum has shifted from North America to Europe. More deals are now done outside than inside the US. Europe is the main beneficiary of this trend and this at least partly explains why European equities continue to outperform US equities.

Secondly, most deals in this cycle are cash transactions as opposed to the previous cycle where stock deals dominated. This holds important implications for global stock markets because every time a cash deal is executed, a significant sum of money has to be recycled into other equities. In other words, private equity transactions provide significant and ongoing support to equity prices.

Thirdly, more activity is now financed through loans – secured as well as unsecured - and through the issuance of corporate bonds as opposed to equity, when compared to the last cycle. About six or seven years ago a typical leveraged buyout would include 30-40% equity participation. Now that number is down to 15-25%.

You may wonder why the average private equity manager is comfortable with such a low equity participation rate. The explanation may be found in the holding period for a typical private equity investment. The offering memorandum of a private equity fund will tell you that you should be prepared to be invested for the next seven to ten years. The reality is very different, though. According to the latest data from Thomson, the average holding period is now about 2 ½ years.

Another reason why the equity (and senior loan) participation has dropped is the appearance of new instruments in recent years. Second lien loans, mezzanine notes and PIK (payment-in-kind) notes have all emerged in the last few years. For example, in 2003, senior loans made up 62% of all loan finance in an average European LBO compared with 33% now.

The commercial banks play a key role in financing a leveraged buyout, although the role has changed somewhat over time. Five years ago, 95% of the loans ended up in the banks' own portfolios. Today, the banks still facilitate the vast majority of loans but about 50% is passed to institutional investors such as CLO funds and hedge funds. In short, this is how a typical transaction works:

When a private equity manager decides to bid for a company, his first call is to the bank(s). This conversation will establish how much finance the bank is prepared to provide. As the propensity to lend - and the desire amongst institutional investors to invest - is at an all time high, the private equity manager will usually find that he has more capital available than at any point in the past.

Now, if the average private equity manager has access to more capital than ever before, he can obviously afford to pay a higher price. With more private equity funds in operation than ever before, this can only lead to higher multiples being paid for the average buyout. This was confirmed in a recent survey conducted by the Financial Times (see chart 1), which suggests that the average EBITDA[1] multiple paid has risen from just over 6 times to in excess of 8 times in the past six years alone.

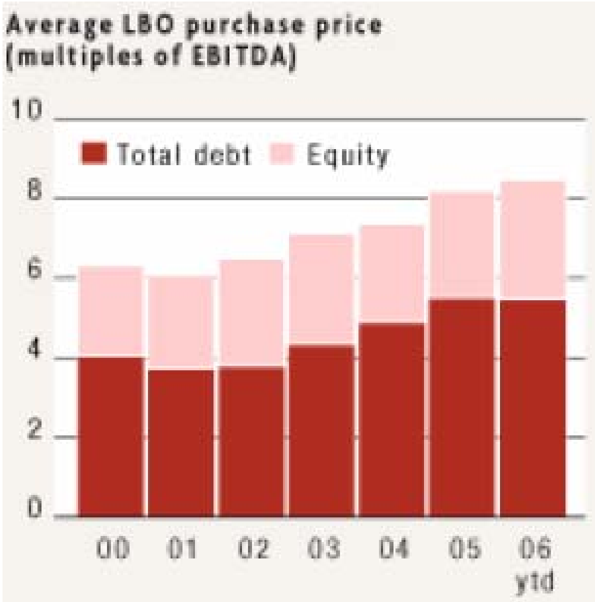
A typical transaction five years ago would look like this:

Senior secured loans: 3.0-3.5 x EBITDA
Including high yield: 4.5-5.0 x EBITDA
Including equity: 6.0 x EBITDA

Today the picture is quite different:

Senior secured loans: 4.5-5.0 x EBITDA
Incl. second liens, mezz. & HY: 6.5-7.0 x EBITDA
Including equity: 8.25 x EBITDA

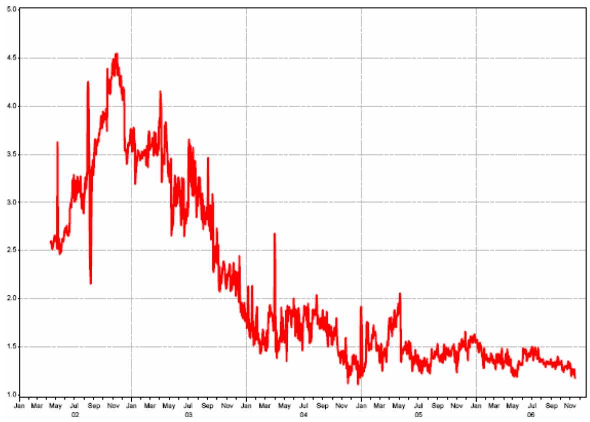
Chart 1: Buyout Prices on the Rise.



Source: FT. Based on S&P and Dealogic data.

The buyout activities are being further helped by record low credit spreads as shown in chart 2. The chart illustrates the spread between BBBs and AAAs; however, a typical leveraged buyout will consist of bonds with a credit rating of B. Five years ago a B-rated corporate bond would trade at perhaps 650 basis points over the corresponding AAA paper. Now that spread has been reduced to 450-480 basis points.

Chart 2: 10 Yr UST v. BBB Spread.



Source: GaveKal Research and Ecowin.

What the sales person doesn't tell you, though, is that the capital structure in many of these buyouts is vastly different from the picture only five or six years ago when we experienced the

[1] *EBITDA equals earnings before interest, taxes, depreciation and amortisation and is used widely to price leveraged buyouts.*

last recession. Over the past 20 years, the average recovery rate for a high yield bond in default has been around 40%. Today, should the EBITDA multiple drop to 5-6 times in a credit crunch-like situation, most senior secured loans will still be in-the-money but the recovery rate on a typical high yield bond could drop to close to zero and your investment could be wiped out. This is a *very good* reason not to fill your portfolio up with corporate bonds these days!

We suspect that the market is perhaps getting a little bit complacent as a result of default rates being unusually low in recent times. The long term average is about 4.5-5%. Year to date, the default rate has been as low as 0.47%.

Back to the buyout story. Short of a substantial financial accident or a major economic slowdown, we do not see an immediate slowdown of leveraged buyouts. There is simply too much money flushing around the system.

There *will be* an accident at some point, though. We would be very surprised if one or several of the existing buyouts do not keel over in the next recession. If it were to happen to one of the high profile names that could fundamentally change the market.

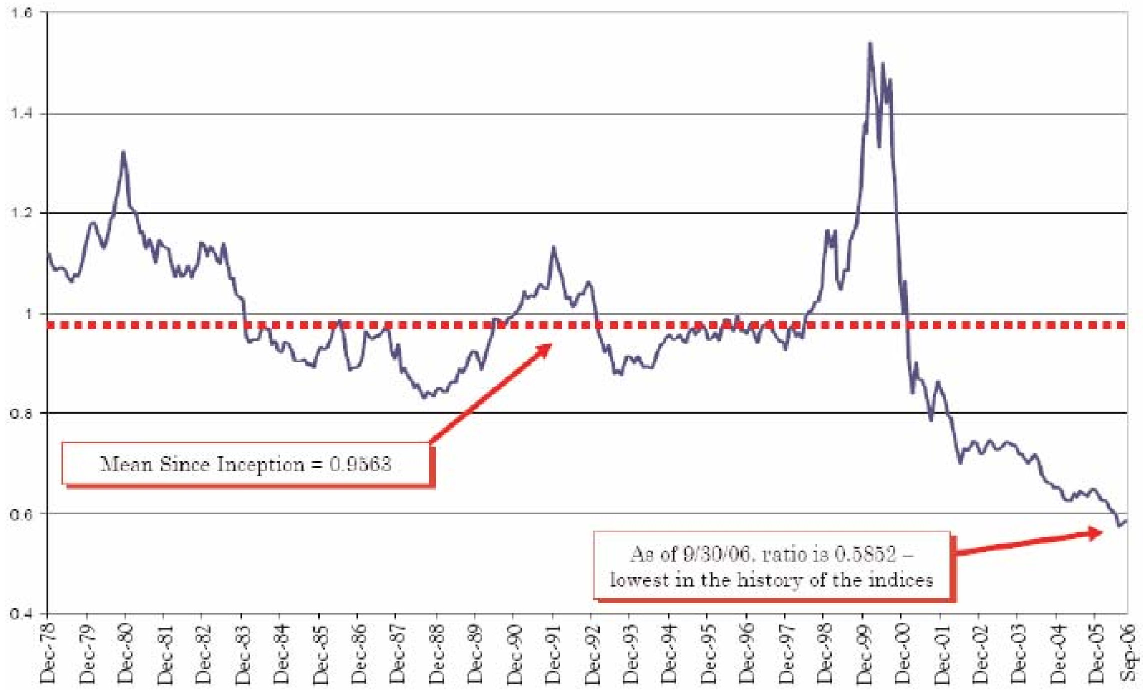
In the meantime, the buyout wave will continue to provide stimulus to global stock markets. In recent months, we have come across numerous stock market commentators who have made the point that the market is overdue for a style shift back to growth stocks. As you can see from chart 3 below, value stocks have outperformed growth stocks every year since 2000 and are starting to look relatively expensive.

What you must remember, though, is that the vast majority of all leveraged buyouts are picked from the value basket. So, if buyouts continue to fuel global stock markets, value stocks will most likely outperform growth stocks.

At the other end of the capital structure, there are now several funds specialising in secured bank loans. So if you want to participate in the buyout wave, but do not like to be tied up for five years or longer in a private equity fund, you can do it through either value stocks or through funds which specialise in secured loans. We would be happy to provide specific ideas in either area. Just don't play the high yield market. That is indeed an accident waiting to happen.

Niels C. Jensen

Chart 3: Valuation of Growth v. Value Stocks.



Source: www.navellier.com. Calculation based on Russell 1000 index.

The Dollar Club

Try and imagine you live in a country where you can borrow at 6-7% per annum for a return of about 15% - obviously not guaranteed but pretty good odds. Would you do it? Of course you would. Now, imagine that country is China.

Hold your horses, you may argue. The cost of borrowing is higher than 6-7% in China. More like 10-12% for the average entrepreneur. Well, don't bet on it. As the world increasingly becomes one big open market place, and the Chinese authorities stubbornly maintain their view that the best recipe for China is a Yuan which closely follows the US dollar – albeit with a couple of percentage points of annual revaluation thrown in for good measure – borrowing in US dollars to invest in China carries little or no perceived currency risk.

In a recent article in the FT fm[2], some interesting observations were made in terms of the implications of large emerging economies such as China deciding to shadow the US dollar. In fact, the dynamics are not terribly different from those of the EU, where several countries have enjoyed an unprecedented boom in recent years as a result of the "one size fits all" monetary policy forced upon us after the introduction of the euro.

Had countries such as Denmark[3], Ireland and Spain been able to determine their own independent monetary policy, interest rates would most likely be higher in those countries today. However, these countries, and more, have benefited from the fact that ECB's policy has largely been dictated by the sicklings of Europe, i.e. Germany, France and Italy.

When credit is cheap relative to expected returns, it encourages increased borrowing. It is as simple as that. There are obviously other measures available, should your government be keen to slow down the economy, but with monetary policy outsourced to the eggheads in Frankfurt, membership of the euro club has effectively stripped its members of the most effective tool available.

Now, let's go back to the Chinese example. Access to cheap capital has a number of implications – positive as well as negative. One of the most obvious ones is asset inflation, in recent years manifesting itself through higher property prices and buoyant equity markets all over the world. It should also be noted that China is not the only country linking its currency to the US dollar, although some tie ups are more formally established than others. The currency peg approach has been fashionable in Asia for years and is now spreading to other parts of the world.

This also helps to explain why so few emerging economies are running current account deficits – contrary to economic theory which suggests otherwise. Normally, when a country runs a large surplus, currency appreciation will, over time, reduce the level of competitiveness and thereby reduce the surplus. However, when the currency is artificially held down, as is the case with China and certain other countries, no such mechanism is in place to address the imbalance.

Another, and potentially positive, side effect from the *Dollar Club* phenomenon is the effect an American slowdown may have on the other members of the club. It is an almost universally accepted view today that a meaningful US slowdown will have negative implications for growth in other parts of the world, as many emerging economies are export driven. However, this argument fails to address the rebalance of economic growth which may happen as a result of lower US dollar borrowing costs.

Let's assume for a second that the US economy were to go into recession at some point in 2007 (for the record, we do not expect this to happen). The Fed would almost certainly lower the Fed funds rate in order to stimulate domestic demand. Meanwhile, as a result of even cheaper credit amongst the other *Dollar Club* members, growth in these countries could in fact accelerate.

So far so good. More worryingly, the long term implications for inflation are not encouraging. Eventually, excessive levels of liquidity will not only feed into asset inflation but will also put upward pressure on consumer price inflation. How long it will take before this problem becomes apparent is difficult to say. What we can say, though, is that when the problem is there for everyone to see, it will be a difficult one to handle for the local monetary authorities, as they will find that they have lost the ability to effectively control monetary policy, just as it has been the case in Europe.

How markets will react to that situation is anyone's guess. One thing is sure, though. The only lasting solution is to allow all currencies to float freely. Only then will the imbalances we are currently experiencing be addressed once and forever. However, as long as the Chinese (and others) show a complete disrespect for fair play, the chances of that happening are probably quite remote.

Niels Jensen

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2 *"Mighty Dollar Club still in the ascendancy", FT fm, 20th November, 2006.*

3 *Denmark has not formally adopted the euro but follows a monetary policy which for all intents and purposes is equal to that of the ECB.*

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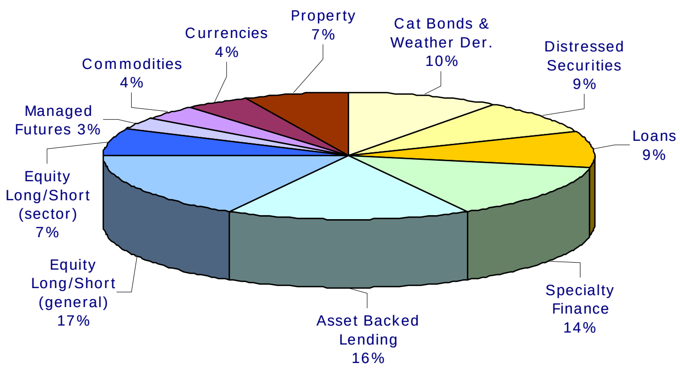
The **Multi-Strategy Portfolio** as at 1st November, 2006:



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