Debt Advisory

Debt Markets Update

January 2010

Welcome to PwC Debt Advisory's January 2010 market outlook, which looks at recent trends in the credit markets and our views for 2010.

Since our last update, there have been encouraging signs of confidence returning across a broad spectrum of bank lending.

The mild softening in pricing and longer tenors in corporate lending, a number of new leveraged buyouts and the re-entry of banks into the commercial property market (on a selective basis) all presage a more active banking market in 2010.

There is also initial evidence that banks are considering taking underwriting positions (e.g. Apax's acquisition of Marken), a key milestone in a return to more normal lending conditions.

The bond market has been the success story of 2009. UK volumes of €65bn were 12% up on prior year, at a time when syndicated bank lending slumped by 52% to €33bn. Confidence in the market saw an increasing number of lower rated issues being successfully launched, culminating in the re-opening of the high yield bond market after a two year closure.

Whilst large FTSE 100 companies are used to tapping the capital markets for debt funding, mid sized borrowers have historically opted for traditional bank finance. However with a significant number of issues in the £150m to £300m range this year, this form of finance is appropriate for a wider range of corporates and enables a borrower to diversify its lending sources (a key lesson of the last 18 months).

2009 was also a year dominated by high profile and complex restructurings (e.g. Rusal, Gala Coral, IMO Car Wash). There was a slow down in the number of new cases in the second half of the year. However, unfortunately there are plenty of reasons to believe that there will be a steady stream of borrowers having to renegotiate their existing facilities over the next two to three years. Those leveraged buyouts that have managed through the recession thus far face tightening covenant levels and bullet maturities, principally from 2011 onwards. With leverage on new finance significantly below the peak levels in 2006/7, there is a significant risk that these deals will need to be renegotiated.

The Commercial property market has been one of the sectors most impacted by the credit crunch, with property values 45% below the peak. Where borrowers continue to service debt, we have generally seen lenders taking a supportive stance of over-leveraged credits. However, if there is a payment default and/or a new money requirement to complete a development, they can take a much more robust stance, in some cases taking a controlling equity stake.

Overview

The ‘maturity cliff’ is closer for the commercial property sector, which has been one of the worst affected by the credit crunch. In our experience, lenders have been supportive of over-leveraged borrowers to date, as long as they continue to service their debt. However, as five year money begins to mature on a number of deals this year, the reduction in available leverage on new finance will create a significant funding gap. In these situations, lenders may be more robust in demanding significant equity positions, unless the shareholders can provide new money.

This document looks at some of the recent trends in the Corporate Banking, Property Finance, Leveraged Finance, Corporate Bond and Asset Based markets. We also comment on recent trends in Debt Restructuring.

PricewaterhouseCoopers LLP has dedicated debt advisory personnel in all major UK centres and relationships with major banks, funds and bond investors in all key credit markets. We have been active throughout the ‘credit crunch’ and some of the transactions we have recently advised on are presented on page 27 of this document. As always, your feedback and responses are extremely valuable. We would welcome the opportunity to hear your views and to discuss how the issues raised here might affect your business.

Simon Boadle
Head of Debt Advisory
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Focus: UK Property Finance – is there light at the end of the tunnel?

Introduction

- In this section, we consider conditions in the commercial property market, both in terms of working through over-leveraged credits and the ability to tap new finance.
- Whilst all credit products and business sectors have been affected by the contraction in bank lending and risk appetite, the Real Estate sector has been impacted considerably more than others. The financing market for new property-related lending has effectively been closed since mid 2008. However during the second half of 2009, we have seen encouraging signs of renewed appetite.
- The volume of debt secured against the UK real estate sector fell in 2009. Though the fall of c.0.8% was modest (i.e. from approximately £226bn as at December 2008 to c.£224bn as at June 2009), this was the first recorded drop in the aggregate value of real estate outstanding debt since the review started in 1997.[1]
- The primary issue facing the market is the precipitous decline in property values over the last two and a half years (45% since the 2007 peak). Consequently, many property firms are facing very stretched loan-to-value ("LTV") ratios and in some cases even negative equity. Savills head of UK valuations, William Newsome, recently estimated that UK property is facing between £38bn and £50bn negative equity.
- There has been a sharp increase in the value of property loan defaults and breaches in financial covenants. Loans in breach of financial covenants have nearly doubled in the first six months of 2009 to approximately £30.5bn of which c£11.8bn relate to payment defaults, with the remaining c£18.7bn relating to breach of financial covenants. [1]

Lenders' reactions to covenant breaches

- Banks are drawing a clear distinction between those loans that are in breach because interest or principal are not being paid and those where just LTV breaches have occurred.
- As a general rule, providing interest payments are met and borrowers are co-operative, most lenders are supportive, tend to ignore or postpone property valuations and are also likely to amend the terms of the debt, e.g. through providing an increased LTV. However, this support comes at a price. Lenders typically command an increase in margins and fees and, where possible, accelerated repayments (e.g. through disposals or new equity) with a view to reducing their exposure ahead of maturity.
- However, problems in meeting interest cover tests are likely to result in lenders taking a more robust stance in the negotiations with the existing shareholders. Currently, this form of breach is affecting development loans in particular where there is limited income and often a new money requirement to complete projects. In these cases, lenders have required shareholders to contribute additional equity to support the business.

UK Property Finance – Lenders' reactions to defaults and refinancing issues

Lenders' reactions to covenant breaches (cont)

- Lenders have typically tried to avoid debt-for-equity swaps or selling assets to avoid crystallising losses.
- We have seen banks contribute more money to situations where this could improve their position in the medium term (e.g. to finish a development). Critical in the decision making process is also the size of any new money requirement. If this is significant, the banks are likely to require a substantial equity stake in the business (perhaps even taking full ownership of the business) or another method of profit sharing so that they can take full advantage of the increase in value following the turnaround implementation and the market recovery. This may give rise to a variety of tax and structuring issues.
- Where possible lenders prefer to continue to work with existing management teams, providing that they think the management is capable. Those borrowers with a limited track record who simply used property as a tool for financial engineering are most likely to see banks step in.
- We have seen a number of instances where property lenders avoid taking over businesses or implementing debt-for-equity swaps as they are nervous about the associated bad publicity. Banks do not want to be seen as unsupportive to existing clients during the current difficult market conditions.
- Some 69% of the £225bn debt as at December 2008 will mature in the period 2009 – 2013 (of this 19% is in 2009 and the remaining 50% is in the period to 2013). [1]

Refinancing issues

- Refinancing with new banks is proving very difficult in high LTV scenarios, and in many cases extending maturity of the existing loans is proving to be the only option for both borrowers and banks. Given the contraction in available new lending, the re-financing process needs to start as early as 18 months in advance.
- The CMBS market faces particular issues. More than £8bn of real estate securitised bonds are due to be re-financed by the end of 2010, with the same figure again due to be re-financed in both 2011 and 2012. [2]
- In the US, one response to this seems to be an agreement to extend the period of the loans to a point in time when the CMBS market would have potentially recovered. This solution however might not suit all groups of bondholders, leading to potential legal conflicts.

UK Property Finance – Government intervention and new lending

Government intervention

- There are two Government schemes which will have an effect on commercial property, namely the UK Treasury Asset Protection Scheme ("APS") and the Irish Treasury National Asset Management Association ("NAMA"). The two offer different solutions to the problems banks face.
- The APS will guarantee losses on pools of assets selected by the participating bank, RBS, and the Government. Banks will absorb the first loss of up to 10% and the Government will cover the remaining 90% on assets covered. Under the APS, assets are still to be managed by the banks, rather than transferred and managed by the government.
- The general consensus is that the APS will lead to RBS holding more assets and working with borrowers rather than calling default. It is thought that there is little benefit in the bank calling default on loans covered by the scheme and flooding the market with unsalable assets.
- The Irish scheme differs in that the NAMA will buy up to €90bn of loans from Irish banks. The focus is mainly on Ireland, but will also include a significant amount of UK property loans.
- The main issue surrounding NAMA will be the price at which loans are transferred. If the price is too high, the taxpayer will be deemed to have overpaid. If, however, assets are transferred at too low a price, banks will have to take write-down and hence need further re-capitalisation.

New Lending

- There appear to be some signs of renewed appetite for Real Estate lending in the second half of 2009. As a general rule, banks remain cautious and conservative and are often reluctant to advance loans to new customers. Consequently, any "new money" lend will be strictly examined and will take considerable time to be credit committee approved and completed.
- The number of active banks has increased again, with most of the main commercial banks carefully returning to the market, together with some specialist European property lenders (mainly German).
- In terms of advancing funding, banks will typically look for prime location commercial properties that have stable cashflow generation. Lenders would appear to have very little appetite for lending against land banks or sites and speculative developments until the end of 2011 at the earliest.
- Typical margins for "new money" or restructured property loans are in the range of 300 basis points ("bps") - 350bps, even for the most creditworthy of companies. As well as significantly increased margins, arrangement fees of up to 5% of the loans' value are also quite common in the current market. The maximum likely maturity of newly granted property loans is five years with LTVs of around 65% for senior debt. A small group of lenders can stretch this to 75% for the most prime of assets, by using a Mezzanine tranche.

Sources

1. UK Commercial Property Lending Market Report from De Montfort University (2008 Year End and 2009 Mid Year);
2. IPF UK Real Estate Debt: A Problem for the Borrowers and the Banks (July 2009)

Corporate Lending

Key trends

We continue to see a generally improving sentiment, with banks demonstrating a more positive outlook and appetite for new financing.

We are seeing lenders responding more positively to new customers that have shown resilience through the last 18 months, and are perceived to have a positive outlook.

Overall market liquidity appears to be improving and a number of larger transactions are now being completed or announced. The most topical of which is the Kraft/Cadburys transaction which is being funded through c.£7bn of debt finance – ultimately expected to be funded through the bond markets.

There is arguably a gap between the jumbo deals that are readily funded through the bond markets and larger mid-market transactions requiring, say, over £300m of debt, where a combination of bank and bond structures are starting to be seen. Historically these funding structures have been relatively unusual in the mid-market arena but could be an increasing trend if bank liquidity doesn't rise to match demand. HM Treasury has recently issued a discussion paper aimed at exploring non-bank lending alternatives.

Recent strong activity and appetite in bond markets have also helped improve sentiment in bank markets, and the general consensus is that levels of M&A debt funding are expected to recover during 2010, which will support an increase in corporate activity.

Auditors continue to concentrate on how a company's financing arrangements support going concern opinions, with most Finance Directors therefore focused on early resolution of refinancing requirements – in many cases 18 to 24 months ahead of the existing facilities' maturity date.

Outlook for 2010

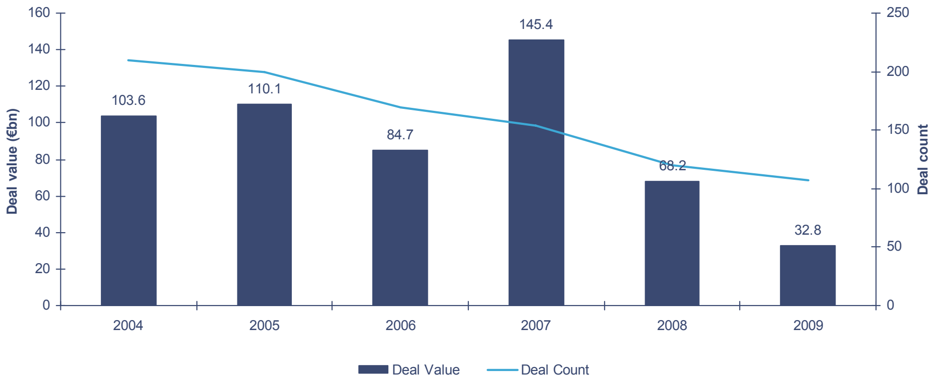
- Except for the potential impact of another substantive credit event, we believe there will be a continuation of the gradual improvement in bank confidence, driven by:
  - an overall improvement in the UK and European macro-economic environment,
  - banks' balance sheets recovering from credit shocks
  - a gradual increase in the number of banks (and possibly funds) providing enhanced liquidity,
  - an initial number of underwritten deals being successfully sold-down into the wider bank market.
- Whilst we expect pricing to be positively impacted by the gradual return of liquidity, there has been a structural change in the way credit charges are assessed and we do not foresee a rapid return to pre-crunch pricing.

Corporate Lending

Lending volumes and market sentiment

- Not surprisingly 2009 ended as the lowest year for corporate lending volume and aggregate value since 1994. According to Dealogic, there were only 107 investment grade syndicated bank deals in the UK during 2009. These amounted to only €32.8bn, a 52% decline on the prior year, in value terms. The dearth of Merger and Acquisitions ("M&A") activity means that the majority of these transactions related to refinancings rather than genuine new money finance-raisings.
- Typically the lowest quarter, deal values in the final three months of 2009 were only €2.9bn compared to €6.7bn in 2008.
- The principal focus of bankers during 2009 was either on restructuring under-performing transactions or re-financings of non-stressed corporates. However we have observed a marked improvement in sentiment in the final quarter of last year and a more noticeably more positive outlook.

UK volumes – Investment Grade (AAA to BBB-) Corporate Lending



Source: Dealogic LoanAnalytics

- Volumes in the first half of 2009 had were buoyed by the trend for "forward start" refinancings – a result of banks re-committing early to facility renewals to provide their borrowers with more certainty of financing, during a period when nobody was certain that bank market liquidity would recover quickly.
- In the last few months, we have observed a reduction in the number of new forward starts, a sign that corporates' confidence in the bank market is improving. Some market commentators believe that forward starts will now become a solution for stressed businesses that are looking to refinance facilities on an amended basis.
- Improving sentiment is now persuading banks to consider underwriting debt financings. This is likely to start with cautious renewals of existing syndicated facilities and, if these are successful, will move into new financing for acquisitions, etc.
- Greater confidence to underwrite debt will require increased liquidity, which is being helped by a small number of new or re-entrants into the market, and by existing bank balance sheets recovering from the credit shocks seen over the last year. We also expect underwritten deals to be delivered initially on a joint basis by small groups of arrangers so that they can reduce their individual levels of syndication risk. The downside is that this will impact competitive tension for larger deals, but is a necessary step to rebuilding market confidence.

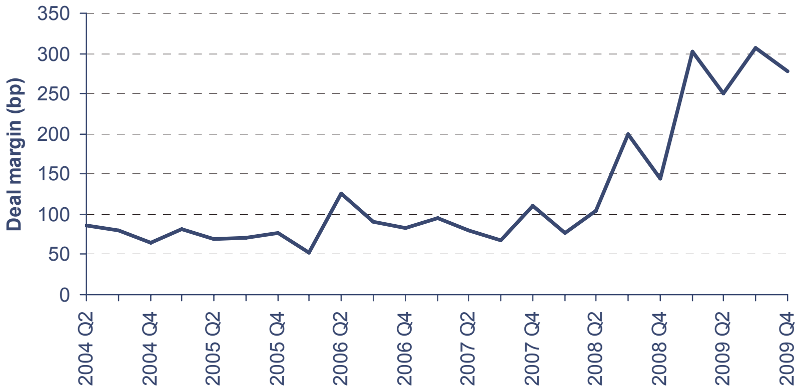
Lending volumes and market sentiment (cont)

- Further recovery in lending appetite continues to be shown by the two UK-government owned banks, who have been given aggressive lending targets intended to support growth in "Corporate UK." From what we have observed, whilst these banks are lending again and are, to some extent, bolstering the market, the levels of new lending by these two institutions is still materially below their targets.

Pricing and maturity

- Relatively low volumes of publicly available data make it difficult to draw accurate conclusions, however our view, formed from talking to clients and other companies anecdotally, suggests that pricing for corporate credits plateaued and possibly eased in the latter half of 2009. The main pricing driver remains market liquidity and transactions that require a larger number of banks will inevitably be more expensive, regardless of the credit profile of the borrower.

UK Investment Grade (AAA to BBB-) average margin over LIBOR/EURIBOR



Source: Dealogic LoanAnalytics

- The chart above confirms the anecdotal view that average pricing ended the year slightly down on the peaks reached in the summer. Within the above sample, margins ranged between 110bps and 240bps for A+ to BBB- graded borrowers.
- In our last review, we signposted the return of five year tenors for corporate borrowers and we have continued to see more progress in this regard. However, longer tenors are demanding higher pricing, with approximately 25bps being payable per extra year over the 2009 "standard" of three years. This could mean a price differential of 50bps between a three and five year facility.
- During 2009 the limited availability of five year tenors did prompt some higher rated borrowers to explore the US Private Placement market (covered elsewhere in this update) as this market does have the ability to provide additional core funding and longer tenors (seven years and beyond). However, the price of a longer maturity is normally less flexibility, particularly around early repayment.

Leveraged Finance

Key trends

Whilst activity in the European syndicated leveraged loan market in 2009 was at its lowest level for more than ten years, there were encouraging signs of life in the last quarter, with more loans written by value than in the previous nine months combined, and significantly up on the same quarter of 2008 (albeit still only €2.4bn).

The market has also witnessed the return of underwriting; e.g. the recent acquisition of Marken by Apax supported by Senior debt of £315m underwritten by Lloyds and currently in syndication.

We expect a relatively strong start to 2010 given the number of deals where financing is currently being arranged (e.g. Siemens Hearing Instruments, British Car Auctions, Ratiopharm, Matalan).

At the smaller end, there has been a trickle of deals throughout the year, although activity remains subdued. This reflects a mismatch between the price expectation of vendors as much as restrictions on the availability of leverage (and the need for a significant equity cheque); a closer alignment of these could instigate a strong increase in deal volume.

Sourcing capital from alternative funders and using less standard forms of finance (e.g. Confidential Invoice Discounting) continue to be important components of getting a deal across the line.

The overall debt leverage in transactions seems to have stabilised at levels akin to the “pre boom” year levels of c. 4.0x EBITDA for total debt leverage, or ca 3.0x EBITDA for Senior debt leverage.

Overall, whilst attracting “new” money in the market remains challenging, a combination of a strong borrower, a group of existing lenders, possibly vendor finance and some of the new alternative sources, make a deal still executable. In the past six months we have raised a number of facilities to support buyouts.

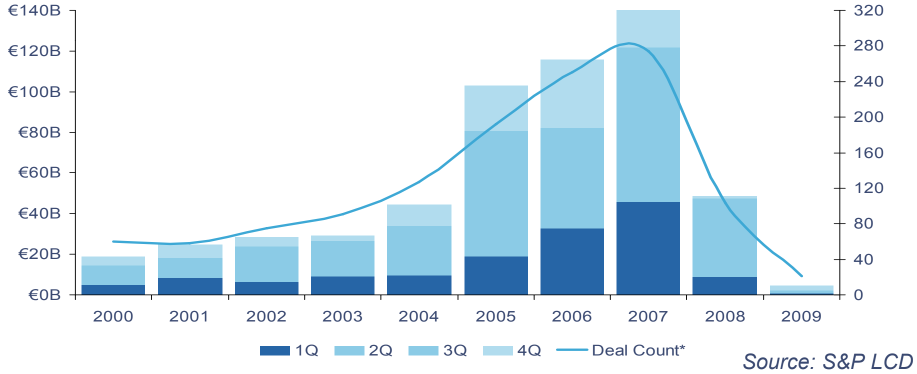
Outlook for 2010

- We expect an increase in deal volumes compared to the very low levels of 2009. A continuation of the levels seen in the fourth quarter of 2009 would indicate a doubling of the annual volume to c. €10bn. The current pipeline is also encouraging.
- We believe margins for Senior debt have stabilised and for the most attractive assets could come under some downward pressure. We do not believe a material increase in leverage multiples for debt is likely in the short term.
- We expect to see the (cautious) return of underwriting and, if the first few are successfully placed, an increased confidence in doing so.
- Purchase price multiples are still well above pre-boom levels and we expect these to reduce. This would also bring the equity proportion more in line with levels seen historically.

Lending volumes

- The low volume of M&A activity has hit the Private Equity ("PE") and Leveraged Buyout sectors. Even compared to the anaemic level of activity in 2008, syndicated leveraged lending fell to a minimal amount of €5bn in 2009, compared to €139bn in 2007. However, half of the activity was in the fourth quarter and the pipeline also looks relatively healthy.
- The majority of mid-market deals are completed on a 'club' basis with individual banks typically contributing no more than £25m each.

European LBO Volumes

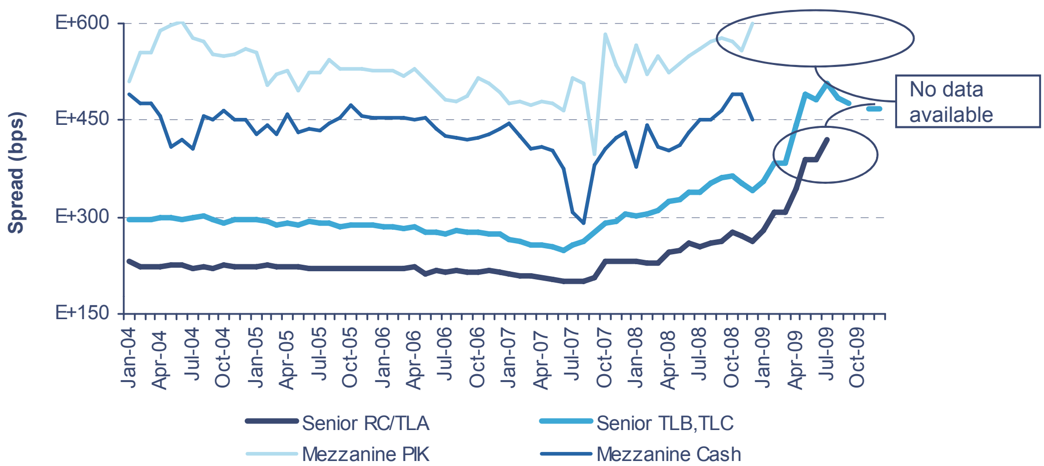


Source: S&P LCD

Pricing

- Average pricing data from S&P is shown in the chart below, with a key observation being that margins ceased to increase and appear to have reached some kind of equilibrium. However, the low deal volume means caution is required on any market statistics on pricing and leverage.
- Based upon our very recent market discussions, we note the following pricing trends:
  - margins for leveraged loans to Libor ("L")+400bps and L+450bps on senior A and B respectively (there is limited call for C tranches in the current market).
  - mezzanine finance margins are currently in excess of L+1500bps.
  - recent deals also indicate arranging fees at around 4% on senior debt.

European weighted average new issue spreads

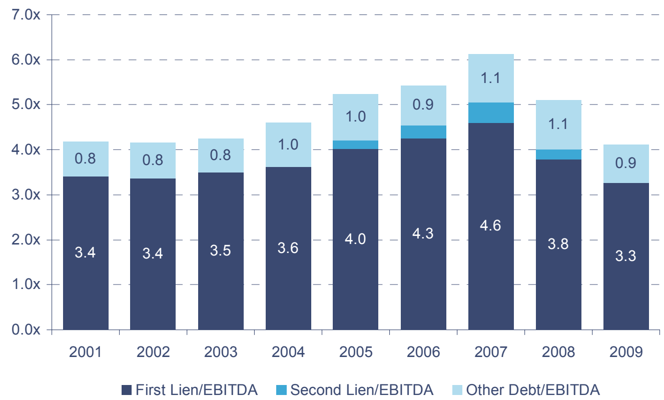


Source: S&P LCD

Purchase price and debt multiples

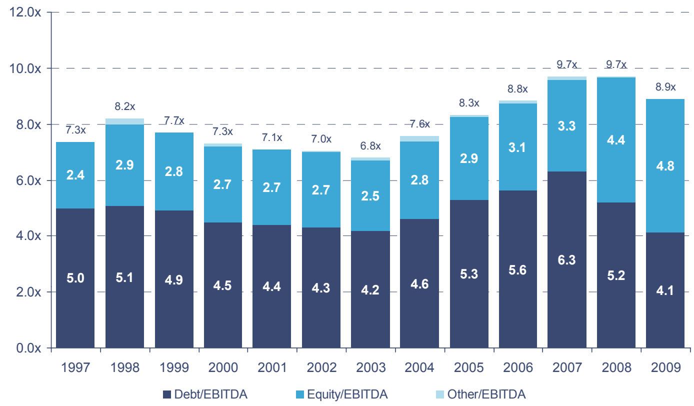
- Average debt to EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) multiples have stabilised in the fourth quarter and appear to have found an equilibrium at levels more common during the pre-boom years.
- After holding up for some time, average purchase price multiples have also started to reduce, but still by much less than debt multiples. As a result, the proportion of equity in new transactions continued to increase and averaged 54% over 2009. This is well above the levels seen in the "pre-boom" years and is unlikely to yield attractive returns for PE investors.
- We expect that 2010 will see a continuation of downward pressure on purchase price multiples, which with stable debt multiples would result in reducing equity contributions, more in line with those seen in pre-boom years.

Annual pro-forma Debt/EBITDA ratios of European LBOs



Source: S&P European Leveraged Buyout Review

Sources of proceeds as a multiple of EBITDA of European LBOs



Source: S&P European Leveraged Buyout Review

Corporate Bonds

Key trends

The UK bond market has remained buoyant throughout 2009, with volumes 12% up on the prior year, at a time when syndicated bank lending fell sharply.

Corporates have been attracted by falling bond yields (BBB spreads have contracted by 45% from March to 330bps in December) and the longer tenors that can be achieved on the public market.

The high yield market in the UK has also seen a significant increase in activity in the second half of 2009, having been effectively closed for the previous two years.

There is still a perception that the bond market is only applicable for large international borrowers, but we believe this is misplaced. There have been a significant number of issues in the £150m to £300m range and the percentage of issues rated BBB and below has increased throughout the year. The public bond market is an attractive way for mid sized corporates to diversify their sources of debt capital; an important lesson of the last 18 months.

Whilst it is too early to call a systemic shift in the balance between bank and bond finance in the UK, we expect 2010 will remain another active year for the market.

The clouds on the horizon are the anticipated winding down of the Bank of England's Quantitative Easing programme, and the UK Government's well publicised debt requirements, both of which could put upward pressure on coupons.

There are also some concerns that the recent number of high yield issues may have (temporarily) saturated that notoriously fickle market, although borrowers continue to be attracted to it given the limited capacity, to date, in the leveraged lending market.

Outlook for 2010

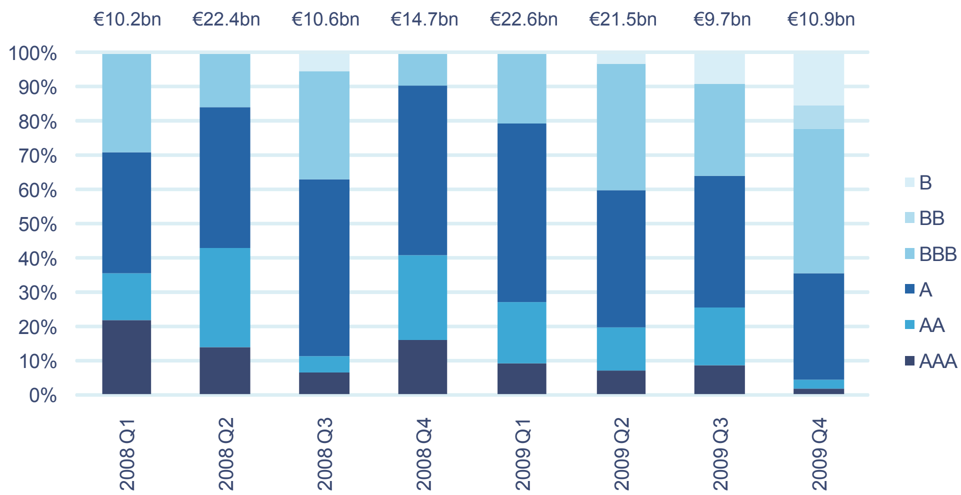
- The positive market sentiment seen in the second half of 2009 has carried forward into the beginning of 2010, with bond issuances remaining relatively buoyant. This trend has been driven by:
  - companies' refinancing requirements and the substantially reduced bank lending capacity;
  - a desire by corporates to take advantage of relatively benign conditions while they last; and
  - investor demand for the still attractive yield on corporate debt (certainly compared to the pre-recession years)
- However, the anticipated winding down of the Bank of England's Quantitative Easing programme, coupled with high levels of debt issuance by the UK Debt Management Office, may create an oversupply of government bonds. Such an oversupply may cause gilt prices to fall and yields to rise, putting upward pressure on coupons for new corporate bonds.
- There are also concerns that the rush by borrowers to issue high yield issuance over the past few months may have (temporarily) saturated the market. A higher proportion of Manchester United's recent £500m bond had to be issued in dollars due to weaker demand from sterling investors.

Corporate Bonds

Issuance

- 2009 saw a 12% increase in UK public bond issuance against that of 2008. Total 2009 issuance was €64.6bn in 2009 vs €57.8bn in 2008; this compares to a 52% decline in syndicated bank lending to €33bn.
- There has also been an increase in the proportion of lower grade issuers:
  - 31% of total issuance in 2009 was BBB rated compared to 20% in 2008; and
  - there were €4.1bn of high yield issues in 2009 (60% of which was in the final quarter).

All UK bonds issued by rating (at launch date)

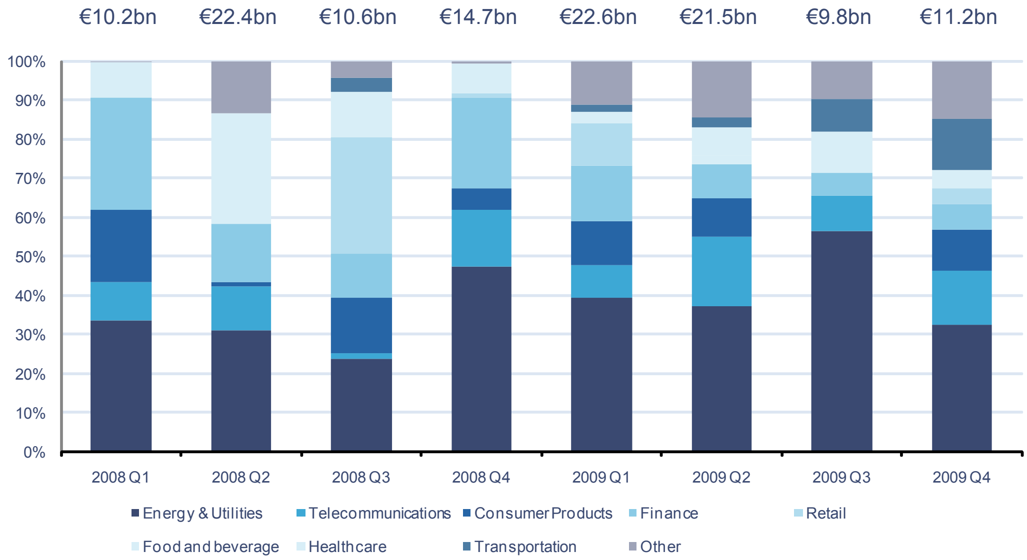


Source: Dealogic DCM

Issuance (cont)

- Excluding issues that form part of a rolling programme, individual issues tend to start at £150m+; the average issue size has been c.£400m in 2009.
- Whilst energy and utilities continued to make up the largest element of new issuance (40% in 2009), bonds were also issued in a broader spread of industries in 2009 including consumer products, retail, healthcare and transportation.
- Financial services issuance in 2009 fell, both in absolute and relative amounts, in 2009, with 10% of issuance (19% in 2008).

UK issues by sector



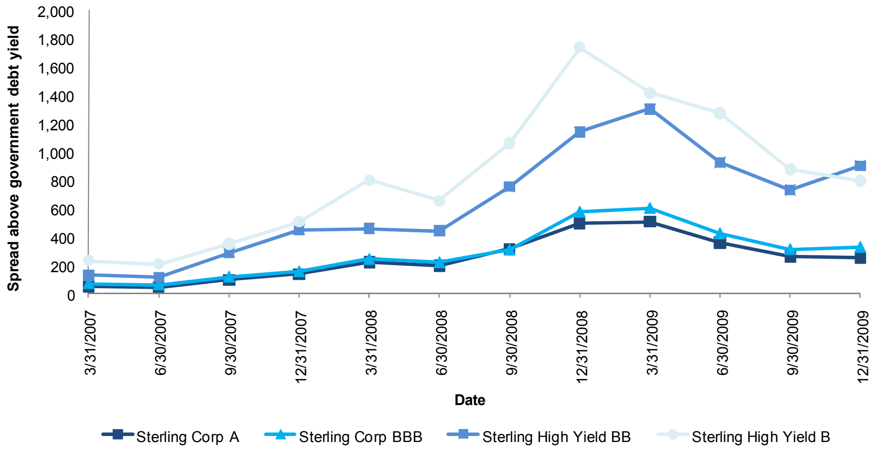
Source: Dealogic DCM

Pricing and maturity

- UK corporate bond spreads (the premium which corporate bond investors demand over gilts), peaked at the end of Q1 2009 (with the exception of B rated bonds which peaked in Q4 2008) and have broadly fallen on new issuances in the last 3 quarters across all rating categories (see graph on following page).
- Average BBB spreads fell to 328bps in Dec 2009 compared to 577bps at the beginning of the year. The fall in spreads has put pressure on loan pricing for ‘big ticket’ financings.
- One of the significant advantages that the bond market offers relative to the bank market is longer tenors. Although some four and five year loans are now being offered, commercial bank market appetite for lending longer than three years is still constrained. The ability for the bond market to offer much longer tenors is a major attraction for issuers.

Pricing and maturity (cont)

UK Corporate Bonds – spread above Government debt by rating



Source: Merrill Lynch

- One recent quirk is the relative increase in spreads for BB rated bonds. This has actually increased to above the observed spread for B rated debt. One potential reason for this increase is the relative low levels of issue at BB, with Q4 issuance of €755m.

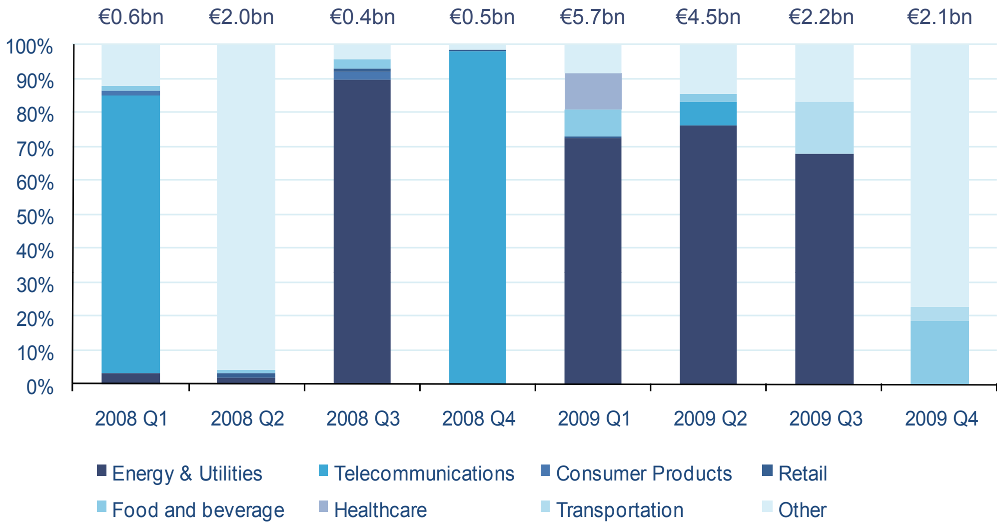
High yield market

- As discussed earlier the fourth quarter of 2009 saw a very strong return by the European high yield bond market, after two years of relative inactivity.
- These bonds have predominantly been used to repay bank and bond debt and to extend maturities.
- A number of corporates have issued sub-investment grade credit in the year-to-date including:
  - Expro, which issued $1.4bn bond in Dec 2009 to refinance all of its senior term loans.
  - Infinis – a £275m issue in Dec 2009 for refinancing existing debt, shareholder loans and general corporate purposes.
  - Inmarsat – a $650m issue in Nov 2009 for refinancing existing senior notes.
  - William Hill – a £300m issue in Nov 2009, increased from £250m, for refinancing and general corporate purposes.
  - Virgin Media – a 2 part deal in Nov 2009 comprising a $600m and £300m issue for repayment of debt. This issue followed on from previous $ and € issues in May 09.

Private placements

- The private bond market may also be attractive to UK corporates for longer-term core debt. This typically involves accessing the US market, which is deeper and more liquid than the UK market.
- The graph below shows the volume of private placement issues by non-financial European companies since the beginning of 2008. Issuance of €14.5bn in 2009 compares to €3.5bn in 2008. Energy and utility companies made up 62% of all issuance in 2009 (predominantly in the first half of the year) and accounted for €8.6bn of the growth in the value of new issues over 2008. This factor also explains why the level of activity has fallen significantly in the latter half of 2009.
- Issuance was spread over a greater range of industries than 2008 (including transportation, construction and chemicals).
- Private Placement new issue size starts at about £60m and is therefore more suitable for corporates who lack the scale to access the public markets.

European private placements (all sectors excluding finance)



Source: Dealogic LoanAnalytics

Asset Based Lending

Key trends

Asset Based Lending ("ABL") remains well positioned to capitalise on the limited credit from traditional sources in the current market.

However, the latest figures published by the Asset Based Finance Association show a 17% drop in total advances to companies in Q3 2009 (£14.5bn) compared to Q2 2008 (£17.6bn). This trend may be adversely impacted by the withdrawal from the market of Landsbanki, a significant player in the UK at the end of 2008, as well as the result of liquidity constraints attached to the ABL subsidiaries of global financial institutions. In addition, lower corporate trading levels will impact lending linked to receivables.

ABL margins have increased in line with the market, by between 50-100bps compared to 12 months ago, albeit borrowing bases are increasingly being aligned to three month LIBOR instead of Bank of England base rates.

The size of the deals that asset based lenders are willing to enter into in the current environment (either on a bilateral or club basis) has also decreased in terms of individual hold levels.

Asset based lenders are positive about the coming year. In 2010, we expect to see some softening in pricing, increased hold levels and the use of junior mezzanine strips to stretch debt capacity in some instances.

Outlook for 2010

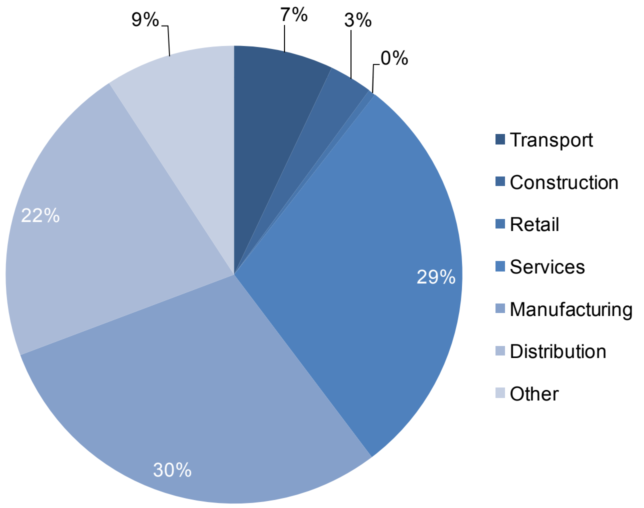
- The general mood in the ABL community seems positive. One major player in the market recently commented that their "order book" of prospective deals was better than it had ever been.
- We expect to see a continuation of the trends discussed above, with hold size rising, the upper end of margin range decreasing, and an increasing number of transactions funded by a blend of ABL and mezzanine debt.

Asset Based Lending

Attractiveness of asset based lending

- Asset Based Lending is a collateralised form of lending which is attractive to businesses of all sizes and across a wide ranges of industries, including manufacturing, distribution and tertiary services. The chart below shows the distribution of UK ABL clients by industry at 30 September 2009 (Q4 2009 data was not available from ABFA at the time of publication):

Distribution of UK ABL clients by industry sector at 30 September 2009



Source: Asset Based Finance Association

- ABL is a flexible alternative financing solution for businesses, particularly those experiencing change, as it can be applied to many different scenarios, ranging from refinancing, restructuring and growth to turnarounds. We recently advised on a buy-side M&A of a European manufacturer where an ABL facility was successfully obtained. In this specific deal, the proposition was unlikely to be attractive to traditional cash flow lenders and ABL offered a viable alternative and increased levels of funding.
- An ABL facility can also flex with the level of trading (of course this can impact negatively if turnover declines) and, if provided on a non-recourse basis, is off-balance sheet under IFRS.

Lending volumes and deal size

- The size of deals which asset based lenders are willing to enter into on a bi-lateral or club basis has changed. In January 2008, GMAC jointly underwrote a £350m deal for Woolworths with Burdale Financial. The market is still capable of writing this size of transaction, albeit that a deal of this magnitude will require a much larger syndicate or club, as most lenders at the larger end of the market have reduced their hold levels to in the region of £30-40m. We are, however, seeing signs that hold size may be increasing and are currently working on a £45m single lender deal.

Asset Based Lending

Pricing and advance rates

- Our discussions with asset based lenders indicate that the appetite to lend remains, albeit at higher margins (increase of between 50-100bps) compared to 12 months ago, (although the upper end of margin range has probably fallen by c 50pbs over the last quarter). Current funding rates are between 175 -300bps for receivables and inventory financing, and between 300 – 350+bps for term debt to finance property, plant and machinery.
- Cash flow lending "top-ups", which were common pre-crunch are also increasingly rare, but as an alternative, we are seeing an increasing number of transactions funded by a blend of ABL and mezzanine debt.
- Advance rates against some asset classes have fallen. Lenders are typically willing to advance up to 85% of receivables, with lower advances for plant and machinery (up to 50-70% of 120 day realisable value), property (up to 50-70% of 180 day realisable value) and inventory (up to 20-50%).

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Restructuring

Key trends

The number of European leveraged companies incurring a payment default or entering into formal restructuring discussions slowed significantly in the second half of 2009. This mirrors our own experience across a broad range of company types.

Lenders indicate that they still expect 2010 and 2011 to be busy from a restructuring perspective. Quite apart from the anaemic macroeconomic backdrop, transactions completed in 2005 and 2007 face tightening covenant profiles and upcoming maturities, which will be difficult to refinance given the reduction in the availability of leverage. Also, those deals that have been restructured continue to carry high levels of leverage and may well require a further round of restructuring.

We have not seen a softening of terms proposed by banks when companies renegotiate facilities following a covenant breach or payment default. Significant increases in margin, back end refinancing fees and warrants all continue to be sought (and often secured) by lenders.

If companies are able to source new equity, however, they are able to soften the pricing increase on the debt.

The majority of restructurings continue to be a negotiation between existing lenders and shareholders with few rescue M&A transactions/refinancings to note. The high yield bond market may be an option for larger credits which are experiencing milder levels of stress, but this is unlikely to be the solution in most distressed situations.

There has been increased activity in the secondary debt market recently (brought about by the general rally in debt prices), with significant quantums of debt being acquired by specialist funds. This can provide an alternative source of capital to fund a restructuring, but can significantly complicate and lengthen it. We have seen restructuring proposals being largely agreed between the borrower and its lenders, only for a new lender to enter the syndicate and propose an alternative deal.

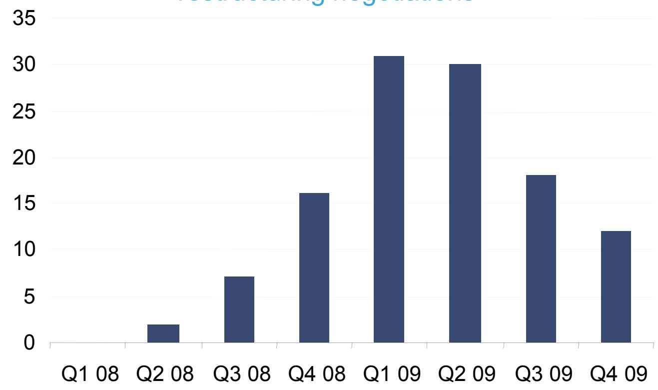
Outlook for 2010

- Whilst there has been a slow down in companies requiring restructuring, we still expect the next couple of years will involve a significant number of work-outs.
- For leveraged buyouts, covenants typically tighten over the life of a deal so borrowers that have managed to trade through the recession thus far, may still face pressure over the next eighteen months, particularly if the recovery is ‘U’ or ‘W’ rather than ‘V’ shaped.
- Commercial property and LBOs also face maturities of bullet debt in the next two to three years. The reduction in available leverage for new finance may require these debt maturities to be restructured. The re-opening of the high yield bond market offers a solution for some borrowers, but it is only likely to be relevant for the larger and less stressed credits.
- Finally, borrowers that have restructured their facilities typically carry high levels of leverage and this may presage a further round of restructuring if the recovery in the economy (and in credit markets) is less bullish than anticipated.

Current restructuring trends

- As shown in the graph below, borrowers incurring a payment default, or having entered restructuring negotiations have significantly slowed in the second half of the year.

Borrowers incurring payment default or entering into restructuring negotiations

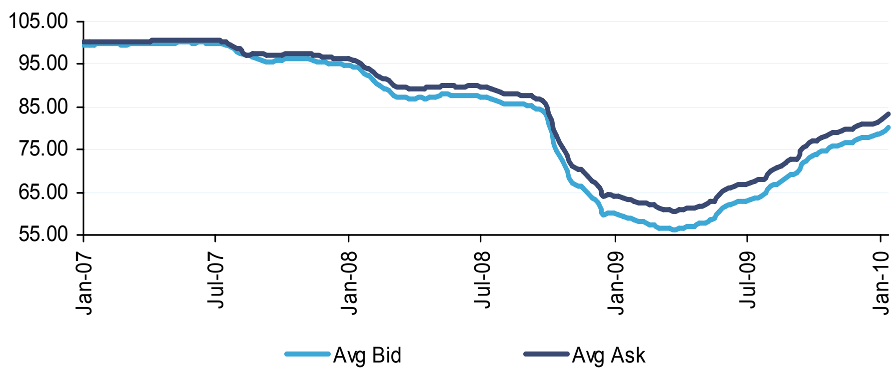


Note: Distressed credits are classified as loans rated D or in a restructuring

Source: S&P LCD

- The majority of larger restructurings involve leveraged buy-outs due to the limited room for manoeuvre in a downturn.
- The limited options in a restructuring in the current cycle (ie. depressed M&A values, inability to refinance debts with new lenders) result in most restructurings becoming a negotiation between the existing shareholder(s) and lenders.
- However, we have seen increased activity in debt trading amongst larger credits. This is partially driven by the general recovery in European secondary debt prices (see graph below), which makes selling debt a more attractive option for incumbent lenders. Also, some banks are keen to dispose of distressed assets that require a high capital weighting.

European secondary debt prices

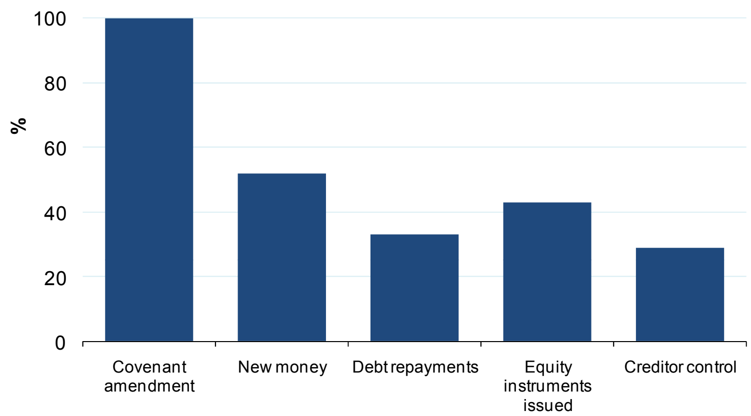


Source: S&P LCD

Current restructuring trends (contd)

- As indicated on the graph below, completed restructurings involve a broad range of solutions:
  - nearly all involve a covenant reset, which is the most common precursor to the commencement of negotiations;
  - a significant percentage have involved new equity to pay down debt. This can be used to temper the requirements of banks for enhanced returns;
  - lenders have not been shy of taking control of the business where they are being asked to take a material write-down. The larger lenders have built up a significant number of equity stakes, which are likely to be realised over a period of some years; and
  - uncontrolled insolvency (ie. the business is placed in administration and the assets sold to the highest bidder is relatively rare, particularly for LBOs).

Restructuring solutions

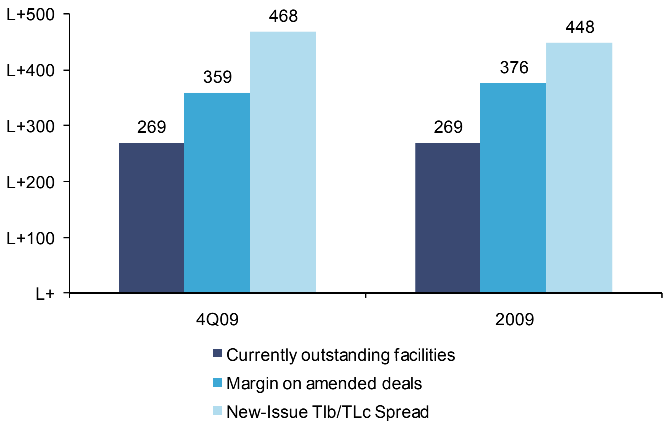


Source: PwC

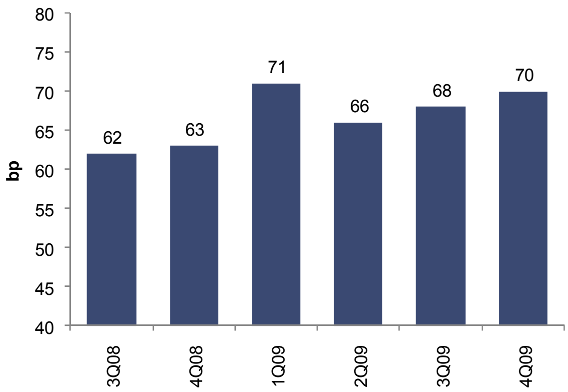
Covenant reset trends

- The graph below left shows the margins on existing LBOs, restructured facilities and new finance. Restructured facilities typically involve a c.100bp increase in margin, but lenders do not typically re-price to terms that would be available on a new deal.
- In addition, lenders typically charge amendment fees between 50bps and 100bps for a covenant reset (see graph below for average on recent deals).
- We recommend borrowers approach lenders significantly in advance of an expected covenant breach. This is unlikely to achieve much of a pricing benefit but gives lenders time to work through the process (often due diligence will be required) prior to the breach actually occurring.

Average margins on LBO facilities



Average amendment fee



Source: S&P LCD

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

- Assess ability to raise non-bank finance (bonds, private placement debt, etc)
- Advise through the bond raising process

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

UK Aug 09 Staple debt finance Dalkia Total Debt £75m	UK Aug 09 Financial restructuring imo Total Debt £430m	UK Ongoing Advising on acquisition finance for a leading car leasing firm Total Debt c.£300m	Europe Ongoing Debt restructuring for metals producer RUSAL Total Debt $15bn
UK July 09 Debt restructuring mecom Total Debt £700m	Europe July 09 ABL acquisition finance CeDo Total Debt €45m	UK Aug 09 Staple Debt Finance Project Prime Total Debt £27m	UK Ongoing Acquisition and Refinancing for Pharmaceuticals Company Total Debt €80m
UK May 09 Financial restructuring McCarthy&Stone Total Debt £900m	UK March 09 Refinancing Sanctuary Housing Total Debt £200m Public Bond	UK Feb 09 Financial restructuring Sea Containers Ltd. Total Debt $1.2bn	UK Ongoing Advising vendor on acquisition finance and working capital facility Total Debt £70m
UK Apr 09 Refinancing Future MEDIA WITH PASSION Total Debt £40m	Europe Ongoing Restructuring of Coeur Defense, Paris Total Debt €1.6bn bonds	UK July 09 Advising an alcohol drinks producer on resetting of covenants Total Debt £355m	UK Aug 09 Debt restructuring NORTHGATE plc Total Debt £900m

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