

September 2007

The way the dominos are falling: A flight to quality in a volatile market

In last month's column in this space, we contemplated the possibility that a timid credit environment – the cause of recent market turmoil – may lead to smaller transactions in the debt market and a renewed emphasis from the still liquid equity community on less leverage-dependent opportunities. With a month and a rate-cut behind us since we speculated along these lines, it seems so far that we were at least partly correct. The rate-cut and its magnitude, however, and economic uncertainties such factors signify, have prompted yet a third dimension in the current deal environment – an apparent flight to quality, that may or may not be temporary – that we will seek to explain in relation to other underlying characteristics.

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1. The debt markets

Despite a significant rate-reduction by the Fed and positive initial indications from the First Data Corp. debt syndication – which had been seen as a sort of bellwether deal by some observers – it does not appear based on reports and anecdotal information picked up along the way, that deal appetite in the credit market has materially improved. Firstly, early signals from the First Data front notwithstanding, this situation may be more a milestone than a bellwether, as the company is not necessarily typical of leveraged transactions in the pipeline or on the horizon. An operator of electronic commerce, payment services and customer account management, First Data Corp. is somewhat insulated from economic swings, has a reasonably predictable revenue base, and is in a well entrenched competitive leadership position. Even so, First Data Corp.'s underwriters are reportedly offering the senior paper at a 4% discount to par value, and had obtained covenant concessions from the company's equity sponsor (KKR) before hitting the market. In the meantime, other leveraged deals have been shelved (e.g., Carlyle's sale of Insight Communications, KKR's acquisition of Harman International).

In this still unstable environment lenders seem generally indisposed to taking on meaningful new exposure to leveraged financings unless on a "buy and hold" basis and without the assumption of syndication risk. Thus, the single-lender transaction and, more commonly, the "club" deal in which a small group of creditors jointly structures and closes a transaction, have become standard. As a consequence, practical limits to transaction size have emerged, as lenders typically prefer not to exceed internal caps to individual credits. This evolution also suggests that lenders – after an extensive period of frothy syndication markets that may have stripped away a layer or two of credit discipline – are once again



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2. The equity markets

While the overall public equity markets have zigzagged during September, spiking or sinking with every new economic report or earnings release, the Wall Street Journal as of the time of this writing noted that on September 25 “three of the best-known tech stocks finished at all-time highs: Google Inc., Apple Inc. and BlackBerry maker Research in Motion Ltd. And the tech-dominated Nasdaq-100 index of large non-financial stocks is now up 18% so far this year, reaching its highest level since February 2001.” Upon a closer look, we find that the same index has significantly outperformed the S&P 500 in the month of September, increasing by roughly 8% during that timeframe, in comparison to the latter index’s rise of less than 5% during the same period (mainly on the heels of last week’s Fed rate cut).

The credit-market status as described may have contributed to this valuation phenomenon. Of the stocks mentioned in the Wall Street Journal column none are exposed to the credit environment in any direct fashion, and this is generally the case for the Nasdaq-100 overall. Consisting primarily of technology companies that are not borrowers of any significance and that have depended on growth without leverage to generate shareholder return, the companies in the Nasdaq-100 are, with exceptions, insulated from debt market hiccups that may still compromise other balance sheets. In other words, public investors – on a relative basis and for the time being at least – seem attracted to stocks that do not depend on a volatile financing environment. And it seems that private equity firms may have become similarly concerned: we have already mentioned several high-profile leveraged buyouts that were in recent weeks shelved or pulled.

On a relative basis, money seems to be favoring not only those opportunities for which financial leverage is of secondary importance, but especially strong-growth high-quality opportunities that fit this profile.

3. A flight to quality

In addition to the previously described conservatism of credit providers and their renewed emphasis on quality and terms, it is also apparent from the overview above that equity markets are similarly showing a predisposition for quality. The leading stocks referenced – Google, Apple, RIM – are among the highest (if not the highest) quality stocks within their respective sectors, and the Nasdaq-100 itself constitutes a sub-segment of the broader composite that includes 100 of the largest domestic and international constituents thereof. As economists voice recessionary fears with growing frequency, and as lenders pose balance sheet risks that are not even cyclical in nature, a preference for less speculative and more stable positions should not be surprising.



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While we are not stock pickers and this is not an investment column, important signals can be gleaned from the public markets to shed light on the deal environment in the stricter sense. On a relative basis, money seems to be favoring not only those opportunities for which financial leverage is of secondary importance, but especially strong-growth high-quality opportunities that fit this profile. As market observers continue to monitor the general economy with utmost sensitivity to both a possible slow-down and inflationary risks, we would expect this trend to continue for a while longer.

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