

MARKET OVERVIEW

WHAT A DIFFERENCE A YEAR MAKES!

Donald Phillips, Founder & Chief Executive Officer

A year ago we were basking in the glow of the fourth year of economic expansion that began in 2003. Our Goldilocks economy was growing at the rate of +3.5 to +4.0%; core inflation was about 2.0%; unemployment was 4.6%; capital from banks was plentiful and the cost of this capital was relatively cheap. The U.S. housing market had just experienced three years of housing price increases totaling +65% nominally and +50% real. All of this translated into global stock market growth that led many investors to believe that 15,000 on the Dow was achievable by mid year 2007. However, many economists, including the Fed, were caught by surprise at how fast Goldilocks' porridge turned cold.

We should have recognized that we are at the top of a market cycle when major financial lending institutions are willing to compete for financing large LBO's using "covenant lite" terms and conditions for a loan. Now "covenant lite" has become "covenant tight" as we experience a global credit crunch that has choked the highly leveraged consumer and corporations that were dependent upon the highly-liquid credit markets. All of this changed when the U.S. mortgage market began to experience the maturity of the 3-year balloon mortgages that were issued with low teaser rates over the past 3-4 years. The Bank of England summed it up by stating that the global debt markets and the U.S. mortgage market have in common the fact that their lending standards have deteriorated in recent years because the banks have been repackaging their debt and selling it to investors rather than holding it on their books.

As this credit crunch spreads across the world, we are experiencing corporate bankruptcies on publicly-traded companies increasing to levels we haven't seen since the record breaking year of 2002. In 2007, we witnessed 11 bankruptcies totaling \$0.7 billion. This compares to the first 45 days of 2008 where we have already seen 13 bankruptcies totaling \$7.7 billion. Not to be outdone, the average percentage of homeowners in the U.S. who have no equity or negative equity in their house is greater than 15% and rising. California's housing market has 25% of houses with no or negative equity.

A year ago, many of us in the private equity business were worried about the amount of capital that had been amassed by the large buyout funds and the impact that capital would have on the price of the companies they were to acquire. Today we are worried about their ability to sustain the financing on the companies they previously acquired as they risk defaulting on this debt. Refinancing of short term debt for existing portfolio companies and the lack of credit for pending acquisitions suggests that the credit squeeze could suspend the acquisition activity of the large cap buyout market globally, because without the availability of credit the LBO model does not work.

Also, if the current credit squeeze continues, it is inevitable that we will see loan defaults on highly leveraged companies that were acquired within the past 2-3 years. We have seen pending acquisitions aborted as debt availability has evaporated and the credit crisis evolves. Breakup fees of up to \$900 million have been paid on a single transaction (PPG Industries) as pending deals are abandoned. However, there will be situations where the buyout fund will be forced to insert more equity into a portfolio company to bridge the company through the credit crunch period. Portfolio returns will suffer because of the magnitude of these transactions, and buyout funds cannot depend upon diversification of the investments to reduce the impact of losses in a portfolio. This would argue that the best case scenario for return expectations for large buyout funds is a single digit return.

The private equity market, like all markets, moves in cycles. We are now about to witness again the rebirth of the distressed buyer. The distressed buyer has a large array of opportunity potential in 2008. The discount offered by a seller who cannot access financing in a tight credit market has historically been significant. The distressed buyer can purchase discounted debt or equity, especially when the equity of the company erodes in a weak stock market. Yet, a distressed buyer is not limited to corporate buyouts. They can also buy large commercial office buildings at significant discounts when the lending bank assumes possession, similar to what happened between 1990-1995. The commercial real estate market is weakening from its overvalued trading prices of the past five years and will continue to do so through this year. However, distressed opportunities don't stop here. The largest single distressed market opportunity today is the U.S. residential market.

The sheer size of the U.S. residential market crisis dwarfs any crisis we have seen before this time. The U.S. mortgage market is in excess of \$10 trillion, greater than the U.S. bond market. The impact of the residential market is not fully measurable because of the lack of market data on the unregulated U.S. housing market. However, it is estimated that the subprime portion of this market is about \$2 trillion. It is also estimated that about 50% of that amount is either in default or at risk of going to default. When interest rates were lowered to 1% in 2001, many of the 77 million baby boomers took advantage of the cheap money and bought or refinanced their house. In some cases this was done many times. This drove up house prices based on market speculation and demand. A market bubble starts when a consumer believes he can refinance his mortgage at a profit. This practice has put even prime borrowers in a position of default when the value of the house drops and the financial bubble bursts. When the mortgage exceeds the value of the house and the balloon mortgage matures the home owner can't refinance the existing mortgage. Even lower interest rates can't prevent this crisis because the current value of the house can not support a mortgage equal to what the homeowner had previously.

Every decade since the 1970's has given the investor an opportunity to make money based upon a major market dislocation or crisis. In the 1980's, it was the emerging markets. During the 1990's the commercial real estate market provided buying

opportunities with depressed prices offering discounts in excess of 60% of the construction value of the property. In early 2000, the technology bubble burst; and now, it is the U.S. housing market which has fueled the global credit crisis creating even more opportunity for the astute investor. Interestingly, each was driven by speculation and availability of unlimited capital. During these periods, lending institutions reduce their underwriting standards as they compete for loans. Market fundamentals seem to only apply after a bubble burst. Therefore, we say to the distressed buyer – happy hunting!

Hopefully, the U.S. mortgage market will be sorted out through the advent of pools of private capital used to refinance millions of single home loans. This will be a daunting task over the next five years. New mortgages are established every day based upon the old fashioned principles of income verification, market appraisals and a minimum of 20% equity invested by the homeowner.

The large cap buyout market and the financially distressed companies created by a global credit market have found a new savior in the sovereign funds in Asia and the Middle East. To date, these funds have invested \$70 billion in recapitalizing some of the world's largest banks. It is estimated that these funds have about \$3 trillion to invest. Interestingly, they have not asked for any control or governorship with these investments. Seemingly, they are looking for rates of return and a relatively safe harbor to place the capital. The international banks represent only the beginning of the investment of this capital because of their need for capital and the price discount that goes with that need. We expect to see the presence of the sovereign funds in other industries as this year progresses. It would not be unexpected to see the sovereign funds join forces with the largest buyout funds to help finance existing LBO companies and future acquisitions.

We have never seen a period of time when a global credit crisis has created the magnitude of distress in the corporate and housing sectors and at the same time the global markets are flush with cash. As this year progresses, we will be witnessing the development of events throughout the global markets where the magnitude and convergence of these crises have never been tested or seen before.