

M&A Monitor

Piper Jaffray Middle Market Mergers & Acquisitions

M&A Monitor: Analyzing M&A Activity—February 14, 2007

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Feature Article

Restructuring Market Update: The Year of Deferment

by Financial Restructuring Group

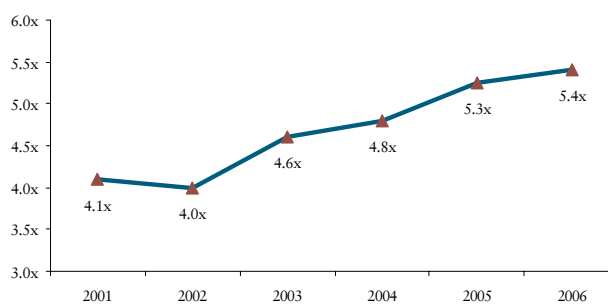
In early 2006, many market gurus predicted the coming year would bring a veritable deluge of defaults. The thesis was straightforward: given the proliferation of lower credit quality debt offerings in 2003 and 2004, a significant portion were sure to go bust two or three years after issuance. As was the case in prior credit cycles, the liquidity provided by the frothy debt capital markets had financed too many businesses beyond their point of comfort and the day of reckoning was near. 2006 has now come and gone, and the gurus are still watching a bubble that has not burst. Instead of a correction, the market's appetite for high yield securities actually expanded to new heights. 2006 was definitely a borrower's market with nearly \$200 billion of new high yield bonds being issued, a healthy 50% increase from the previous year. A more telling metric was that companies rated CCC or lower, the bottom tier of the high yield market, issued over \$34 billion worth of paper last year, compared to \$15 billion in 2005. On the loan side of the market, leveraged loan volume increased over 65% totaling nearly \$500 billion for the year. The much discussed second lien loan market also continued its boom with over \$25 billion issued during the eleven months ending November 2006, a 56% increase from the comparable 2005 period.

Despite all this, defaults seemed virtually nonexistent in 2006, reaching an all time low that approached 1% by the fourth quarter. Compare this to a 2005 speculative-grade average of 3.1% and a historical average for the class closer to 4.6%. Analysts have begun to look back at 2006 as a year of delay and deferment. Essentially, many companies have been able to stave off filing Chapter 11 by accessing low cost capital instead of addressing problems inherent in their business or balance sheet. Some of these companies even underwent multiple refinancings within a relatively short period of time, essentially a strategy of replacing a band-aid with a more expensive band-aid.

It's the Economy, Stupid

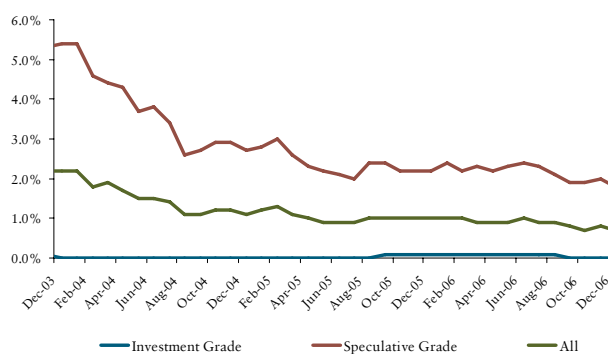
The psychological foundation for the unprecedented level of liquidity in the marketplace has been the state of the U.S. economy. Month after month, economic data continues to be mild enough to placate fears of a near-term hard landing. A healthy labor market, benign inflation, and the ever-shopping American consumer continue to buoy the belief that any correction may actually be a protracted process rather than an overnight evaporation of liquidity. Investors also have faith in their allies at the Federal Reserve to keep a close eye on the numbers and modify interest rates to engineer a soft landing in the face of any turns in the economic tide. Nevertheless, most economists agree that 2007 will bring a slowdown in the economy, with GDP predicted to grow at a rate of 2.3% versus 3.3% in 2006. The inverted yield curve suggests that investors agree that a slowdown is forthcoming. However, after 2006 it appears that few dare to openly predict the timing of the slowdown/crash or the magnitude of the soft/hard landing.

Average Total Leverage Ratios for New LBOs



Source: LCD; Note: Average debt multiples are for large LBOs (more than \$50 million of EBITDA)

Issuer-Weighted U.S. Default Rates



Source: Moody's

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Feature Article, Continued

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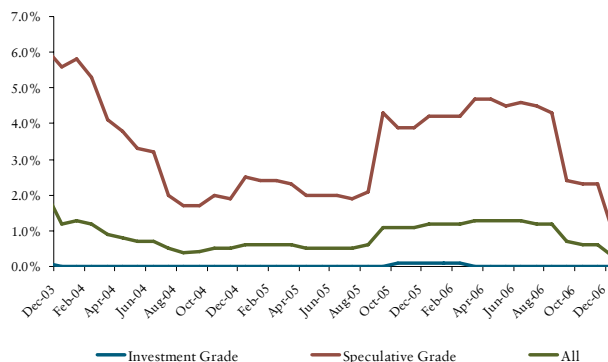
by Financial Restructuring Group

A Different and More Dangerous Game

Feeding the spigot of abundant liquidity has been the proliferation of unregulated investment vehicles, primarily hedge funds, as well as collateralized debt obligations (CDOs). These investors can provide credit with a level of speed and aggressiveness never before available in the marketplace. While some bemoan this new investor class as undisciplined and forming the basis of a bubble, many agree that they bring an increased level of efficiency to the market, albeit in a chaotic way. Stressed and distressed companies are now able to circumvent the traditional lender base and access capital in ways that avoid the need for a full restructuring process, at least in its conventional form.

As the economic tide turns, traditional private equity players will also find themselves deeply involved in many restructurings. Private equity funds raised about \$400 billion during 2006, and as of December 2006 had roughly \$700 billion available to invest. It is no secret that the most levered credits in recent years have been the result of LBOs and sponsor dividend deals, some of which have been priced at cash flow multiples eclipsing even those of the peak markets of the 80s and 90s. When a souring economy and the retreat of the financing markets force a restructuring of many of these balance sheets, private equity players will likely find themselves as investors and board members in a new world order of activist and litigious hedge funds. These impending restructurings may involve a Pandora's Box of issues such as the legitimacy of dividend deals and the treatment of shared collateral borne of second lien financings. It remains to be seen how the courts and regulators will rule on such issues that are deep in uncharted waters and by and large without legal precedent.

Dollar-Weighted U.S. Default Rates



Source: Moody's

When Will the Music Stop?

The one thing that all pundits can agree upon is that what goes up must come down and this high flying market, like all those that came before it, will eventually have to correct in some way, shape or form. Many see a default rate approaching 1% as unsustainable, and more normalized levels to be inevitable. S&P estimates the domestic speculative grade default rate to increase to between 2.5% and 3.0% by late 2007 and has predicted 4% by 2008. This is of course still well below historical levels and relatively modest given the recent exuberance of the high yield market. A much more pessimistic prediction was that made by veteran private equity investor and distressed investing superstar Wilbur Ross, who foresees default rates of 7% to 8% by 2008.

Most experts agree that barring an exogenous world event, the most likely outcome is a protracted economic slowdown that coaxes the markets back to a state of equilibrium. They argue that there is simply too much liquidity out there and the risk is spread out over far too many sectors and types of securities to see a bursting of the bubble like that experienced in the last downturn. Nonetheless, one should remember that given the vast amount of speculative grade debt issued over the last two years, even a slight up-tick in default rates would amount to billions of dollars of securities that would face some manner of restructuring. When the wave arrives, the industries most at risk will naturally be many of the recent high flyers: building materials, home builders, healthcare, and retail/consumer goods. We believe autos and auto parts should continue to suffer, as should businesses associated with airlines as the inevitable consolidation in that industry continues.

Even most optimists agree that the longer the market puts off its return to equilibrium, the broader and more intense the eventual fallout will likely be. What remains to be seen is what form the correction will take, its severity, and which of the players will emerge as the winners and losers of any new paradigm.

Sources: Fitch Ratings Ltd., Moody's Investors Service, Standard & Poor's, New York Times, Daily Bankruptcy Review, Distressed Debt Daily, Forbes Online, Bloomberg

In 2006, Piper Jaffray added a dedicated financial restructuring advisory group to compliment the stable of capabilities we already offer our clients. The team advises companies, creditor constituencies and equity investors in stressed and distressed situations and has advised clients in the restructuring of over \$43 billion in debt over the last decade. For further information, contact us.

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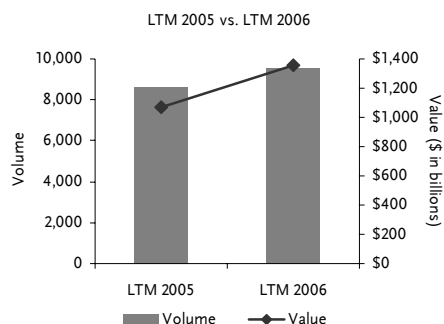
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Domestic Transactions

(\$ in billions)	Value*	Volume
LTM: 2006	\$1,027.7	8,751
LTM: 2007	\$1,400.5	9,771



*Total value based on deals with reported values

Source: Thomson Financial Securities Data Corporation

LTM median deal value for 2007 is \$36.0 million compared to \$30.0 million for 2006.

LTM Transaction Multiples

By Size (\$ in millions)	EBIT	EBITDA
Less than \$25	13.1x	7.4x
\$25 to \$100	11.9x	9.1x
\$100 to \$250	16.4x	11.5x
\$250 to \$1,000	16.9x	9.7x
Over \$1,000	15.2x	10.0x

Current data as of February 7, 2007

Source: Thomson Financial Securities Data Corporation

Based on multiples between 0x and 25x; excluding media and telecom.

Public Company Premiums

1 week prior to announcement	22.8%
4 weeks prior to announcement	26.1%

Current data as of February 7, 2007

Source: Thomson Financial Securities Data Corporation

Deal Financing

	Current	1 Year Ago
Leveraged Bank Loan	7.9%	7.23%
High Yield Bond Rate	7.5%	8.07%
Senior Debt/EBITDA*	4.16x	4.4x
Total Debt/EBITDA*	4.72x	5.2x

Current data as of February 7, 2007

Source: Portfolio Management Data, The Wall Street Journal and LCD Comps

*Represents leverage statistics for middle market LBOs (less than \$50 million of EBITDA)

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Buyout Fund Market

(\$ in billions)	2006	2005
Funds Raised	\$197.6	\$183.8
Deals Completed	\$314.8	\$199.4

Data as of January 8, 2007
Source: Buyouts

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