

M&A Monitor

Piper Jaffray M&A Monitor

Analyzing M&A Activity—May 9, 2007

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Feature Article**Restructuring Market Update**by David Sweig, 312 920-3277, david.m.sweig@pic.com

For even the passive reader, the frothy state of the housing and sub-prime financing markets has been a regular topic in both the popular and financial press for well over a year. What else can be said? Perhaps we can present a slightly different perspective on the origin and potential outcome of the current situation.

In 2004, The Chairman of the Federal Reserve said, "... to the degree that households are ... willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive way of financing a home ... American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage ..." In 2005, he went on to say, "... technological advances ... have resulted in increased efficiency and scale within the financial services industry ... and have brought ... a multitude of new products, such as sub prime loans ... where once more-marginal applicants would simply be denied credit, lenders are now able to quite efficiently judge risk posed by individual applicants and to price that risk appropriately ..." The dearth of cautionary tales and the memories from the last sub-prime meltdown remind us that the age old rule of caveat emptor always applies. Has properly pricing risk ever been a mortgage underwriter's job?

The Yogi Berra Cycle: Déjà Vu all Over Again

A comparison of the Internet-related equity frenzy and housing bubbles results in some striking similarities. Recall the golden age of the day trader—multiple on-line brokerage accounts, margin debt leveraging paper profits, "pump and dump." On-line brokerage firms and accounts grew faster than dandelions in June. Options strategies and getting in on the hot IPO were the topics of conversation among hourly employees at the local fast food establishment. Equity was the currency du jour and "old world" firms like Time Warner snapped up "new economy" firms like AOL. Clicks, unique page views and eyeballs were metrics used to justify stratospheric valuations. Wall Street had moved to Main Street. Fast forward to 2006, when flipping condominiums in Miami or Tucson, cash out financings, home equity lines of credit, the good old "Alt A" loan (where a library card constituted more documentation than required to borrow on average \$192,000) are all the rage. Today's currency is cash, and the credit cycle has made traditional leverage and valuation multiples passé. Private equity deals are growing in both size and number, and fueled by record borrowings, are the rule and not the exception. Cheap money has made multi-million dollar homes, fractional jet ownership and Bentleys the lusted after items on Main Street.

Fundamentals Never Go Out of Style

Looking back only seven short years reminds us of a time when the "pure Internet" companies accounted for only 6% of the total stock market and when sub-prime originations accounted for roughly 9% of total mortgage originations. From 2004 to 2006, sub-prime mortgages exploded to 21% of total originations with approximately 80% of the vintage (i) having loan to value of greater than 80%, (ii) 25% having junior and/or second liens and (iii) 40% being Alt A limited document loans. According to S&P, the 2006 vintages are experiencing a 13% delinquency rate, with roughly 7% being 90 days or more past due. These figures are likely to show further degradation as approximately \$400 billion in adjustable rate mortgages will reset in 2007. The relative magnitude of the problem is highlighted in just the GMAC portfolio, where roughly \$60 billion, or 76%, of the ResCap (the residential component) portfolio was sub-prime and the year-over-year delinquency rate rose by 10%. The top nine^[1] lenders to the sector had roughly \$22 billion of market value erased in the six weeks ending March 31—which does *not* include current or pending write-offs. In context, the S&P 500 gave up almost 50% of its value after the Internet bubble burst. It does not take an advance degree to predict the potential for further deterioration of the 2004 through 2006 "vintages" given the statistics previously referenced. While the incidence of early payment defaults, negative amortization resets and foreclosures will likely spill over into auto and credit card debt, the acceleration across all categories will provide the evidence as to the level of significance on the broader economy.

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Feature Article, Cont.

Restructuring Market Update

by David Sweig, 312 920-3277, david.m.sweig@pic.com

Follow the Smart Money

The vintages of originations in 2004–2006 coincided with a massive industry consolidation largely driven by investment banks and hedge funds. Of the 15 transactions^[2] that closed during the same period, only two traded to strategic/"free standing" mortgage originators/servicers. Three fundamental factors seem to have converged to drive the consolidation: (i) necessity to leverage back office infrastructure, (ii) the importance of "value at risk" (using the balance sheet) and the ability to generate fees through issuing structured finance products and (iii) the maturity of derivative/risk mitigation products such as collateralized debt obligations ("CDOs") and the credit default swap ("CDS") market for mortgage-backed securities. Together, these factors produced unsurpassed opportunities to financially engineer returns and reduce risk by packaging risk into small tranches more easily spread out over a diverse and global investor base. Sub-prime CDO investment grew to \$114 billion in 2006 from approximately \$10 billion in 2001.

In April 2006, a group led by Cerberus Capital Management acquired 51% stake in GMAC. While the transaction appears to have been structured as an effective option on GMAC and seemingly allows for a constant re-pricing of the option, through the years Cerberus has certainly demonstrated its ability to properly price risk and debt. Given the significance of the ResCap loans to the overall GMAC portfolio, one might view this as a bullish bet on the sub-prime space. More recently, other "alternative asset class" investors have made similar bets. Perhaps the investment by Farallon Capital in Accredited Home Lenders and the results from upcoming auctions at New Century and other troubled platforms might suggest that valuation, and not the underlying asset, is the real issue.

Crying Uncle or Wolf?

When the history books are written on this iteration of the sub-prime debacle, the story likely will read more like the boy who cried wolf than uncle from the pain inflicted on the capital markets, liquidity and the general consumer. The credit cycle, globalization of capital and maturity of the derivatives markets have brought an environment of historically low volatility. Together, these forces have served as a significant risk mitigant for the broader markets, and to a lesser extent, the underlying borrower. Personal balance sheets seem to resemble that of corporate America. If there is to be a problem, it is likely to be concentrated in the "high-yield" type borrower since the top 1% of households hold approximately 30% of the assets and 7% of the debt, while the bottom 50% hold an estimated mere 6% of the assets, but a burdensome 24% of the debt. While anecdotal comfort can be drawn from the "soft landing" of the Australian and British housing markets, the U.S. economy appears to face greater risk from possible stagflation, the erosion of the tax base, the weak dollar and the current account deficit. All have been topics in the financial and popular press; perhaps more prudent behaviors will prevent any of these issues from going the way of the sub-prime market.

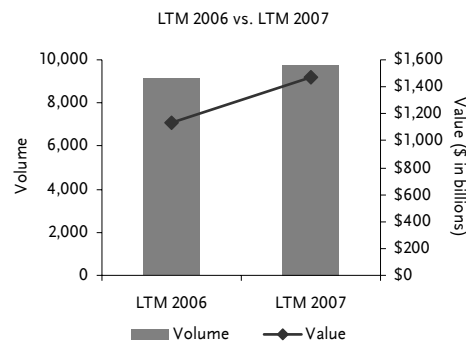
[1] Exclusive of Investment Banking Platforms

[2] Data through Q1 2007

Sources: Bloomberg, The Economist, Barron's, The Wall Street Journal, S&P Data, Loan Performance, Business Week, Wall Street Research

Domestic Transactions

(\$ in billions)	Value*	Volume
LTM: 2006	\$1,133.2	9,128
LTM: 2007	\$1,475.6	9,722



*Total value based on deals with reported values

Source: Thomson Financial Securities Data Corporation

LTM median deal value for 2007 is \$35.0 million compared to \$31.5 million for 2006.

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LTM Transaction Multiples

By Size (\$ in millions)	EBIT	EBITDA
Less than \$25	18.5x	9.4x
\$25 to \$100	12.0x	9.3x
\$100 to \$250	15.6x	11.0x
\$250 to \$1,000	17.4x	10.7x
Over \$1,000	15.0x	10.3x

Current data as of May 9, 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	23.3%
4 weeks prior to announcement	27.2%

Current data as of May 9, 2007

Source: Thomson Financial Securities Data Corporation

Deal Financing

	Current	1 Year Ago
Leveraged Bank Loan	8.01%	7.64%
High Yield Bond Rate	7.44%	8.1%
Senior Debt/EBITDA*	4.6x	4.0x
Total Debt/EBITDA*	5.1x	4.5x

Current data as of May 9, 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)

Buyout Fund Market

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

Data as of May 9, 2007

Source: Buyouts

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