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## Outlook 2007:

# Opportunities abound in 2007, underscored by private equity buyouts, restructurings

By Ronda Fears

Memphis, Dec. 29 - Special situations equity players had a head-spinning time in 2006 and largely expect the pace to extend into 2007, but there is a widespread expectation that the bottom will fall out eventually.

No matter, however, because whether the news is good or bad there will be opportunities to put money to work.

In the event of an uptick in distressed situations and bankruptcies, which many are expecting, traders have noted an influx of interest in bulletin board stocks and some of the bulge bracket investment firms have built bulletin board desks to handle it.

In early 2007, though, mergers and acquisitions are expected to drive activity in special situations equities.

"As long as people are throwing money at private equity firms, we will see more mergers and acquisitions," said Jeffrey Saut, chief investment strategist at Raymond James & Associates.

"These guys are not paid to sit on capital."

The influx of capital into private equity firms in fact has been going on for three years running, and many experts expect it

will continue in 2007. Private equity fund-raising in 2006 approached \$200 billion, according to organizers of the Dow Jones Private Equity Analyst Outlook Conference.

Saut likened the bandwagon for private equity fund-raising to the beer commercial in which Jessica Simpson says something like, "I totally don't know what it is, but I want it."

As a result, 2006 produced record-setting mergers, by size if not in number of deals, mostly funded with private equity, and private equity firms still have pockets loaded with cash for the most part.

But another onlooker said private equity heavyweights like The Blackstone Group, Kohlberg Kravis Roberts, Permira Advisers KB and Texas Pacific Group are not expected to raise new funds in 2007, so that will likely put a dent in the action. But he said additional closes are expected from Apax Europe, The Carlyle Group, CCMP Capital Advisors, Hellman & Friedman, Providence Equity Partners and Silver Lake Partners. In addition, he said there likely will be a handful of new superstar spinouts, such as a next version of Centerbridge Capital Partners, and more new upper- to middle-market funds.

But eventually the liquidity will dry up, players say, and it could happen in a flash.

Determining the event or situation, singular or plural, that will be the catalyst is not so easy, however, with tame economic indicators and a fairly strong corporate America.

### Buying time, bidding time

Phil Arra, president of Hunt Special Situations Fund, expects opportunities in distressed situations to be on the rise

in 2007 because many corporations just bought time in 2006.

"In 2006 the number of bankruptcies declined due the economy being relatively resilient over the past couple of years and the amount of liquidity in the market," he said.

There was robust financing alternatives, and a lot of refinancing, but he expects many of those troubled companies to return to the market for help, likely in the form of bankruptcy or private equity bailouts.

"The problem with that [the 2006 refinancings] is, the way I see the world, is that if you just refinance the company you haven't fixed the way the company is run. The problems don't get fixed," Arra said.

"The leverage multiples are up to all-time highs."

Buying time was a major theme in the capital markets in 2006, and many onlookers and players agree that there are serious troubles still looming.

"2006 was a year of deferrals," said Brett Wyard, co-head of Carlyle Strategic Partners, the distressed team at private equity firm The Carlyle Group.

"Default rates are at an all-time low. If you had asked people 12 to 18 months ago, they would say they expected the markets to break in 2006."

So, going into 2007, the tide is expected to turn.

### 2007 to start with a bang

Extending the flurry of buyouts and mergers, players expect that 2007 will produce lots of opportunity early on for investments along those lines, and when those slack off there will be a shift to more

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distressed situations.

"In 2007, you're going to see an uptick toward the second half of the year in these deals coming to market," Arra said.

"I think the punch line is that there has been a lot of liquidity out there. A lot of these distressed companies have refinanced but they haven't fixed their problem.

"If history is a guide, and I think it is, you're likely to see a rise in the bankruptcy and distressed situations for people like us to invest in, whether it happens in the next quarter or six quarters from now."

### Control tougher to grasp

The playing field is changing, though, with more hedge funds getting involved in distressed buyouts, as well as the means of restructurings and deal structures. That doesn't necessarily mean there are fewer opportunities, but it makes it more difficult for players to gain control of a distressed company.

"What has historically been distressed debt players are becoming more distressed equity players," said Carlyle's Wyard.

"We are shifting to equity underwriters. Our hypothesis, with regard to the second-lien market is that structures are more complicated, there is a greater role of new equity in restructuring. Given the number of players in the market, getting control of a restructuring is more difficult."

Private equity and their massive influx

of liquidity in 2006 have largely accounted for the shifts under way, and that has had an impact on deal structurings, but that is not expected to last forever and, rather, could change rapidly.

### Liquidity squeeze inevitable

Eventually, liquidity in the private equity sector will begin to tighten, however. It always does. Hunt's Arra expects that it will not come until the second half of 2007 or perhaps not until the first half of 2008, though.

Arra said that while the economic picture is not altogether clear, he is looking at the window of opportunity to begin closing in about 18 months.

"Total leverage, the cash flow to EBITDA, is at all-time highs," Arra said.

"So, in 18 to 24 months the markets will tighten."

Thus, business will be brisk going into the New Year but a downturn in liquidity is looming and could happen suddenly.

"When and what is the catalyst? I don't know. Bringing the market into efficiency, into reality, is usually an exogenous event," Carlyle's Wyard said. "Liquidity can change substantially and quickly."

But the U.S. economy is the biggest wild card and the signals are blurred.

"The economy is a mixed bag," Arra remarked.

"We have a weak auto sector. There is

a mixed view on housing. Capital spending is doing well. From the economic perspective it comes down to the consumer. To the negative, we have falling home prices and the Consumer Price Index is high. On the positive, we have increasing wages, unemployment is down and the stock market is doing well."

### Auto, manufacturing pique

With the expectation that there will be Gross Domestic Product expansion in the neighborhood of 1.5% to 2.0%, Arra remarked that "general manufacturing in the U.S. isn't dead. The risk of Asian imports as a competitive threat has to be analyzed on a case-by-case basis."

The Hunt group is "industry agnostic," Arra said, but his interest is piqued by the slumping auto group.

"A lot of people are chasing the auto sector," he commented.

"It's still to be determined how much downsizing there will be. It's not been fully addressed. So we have looked and are continuing to look at that."

Carlyle's Wyard also is expecting further restructuring work to be done in the auto industry and sees another wave of restructuring in the industrial sector to extend into the consumer retail group.

Housing and construction products could be another area to provide some opportunity, Wyard said.