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Credit Market Update

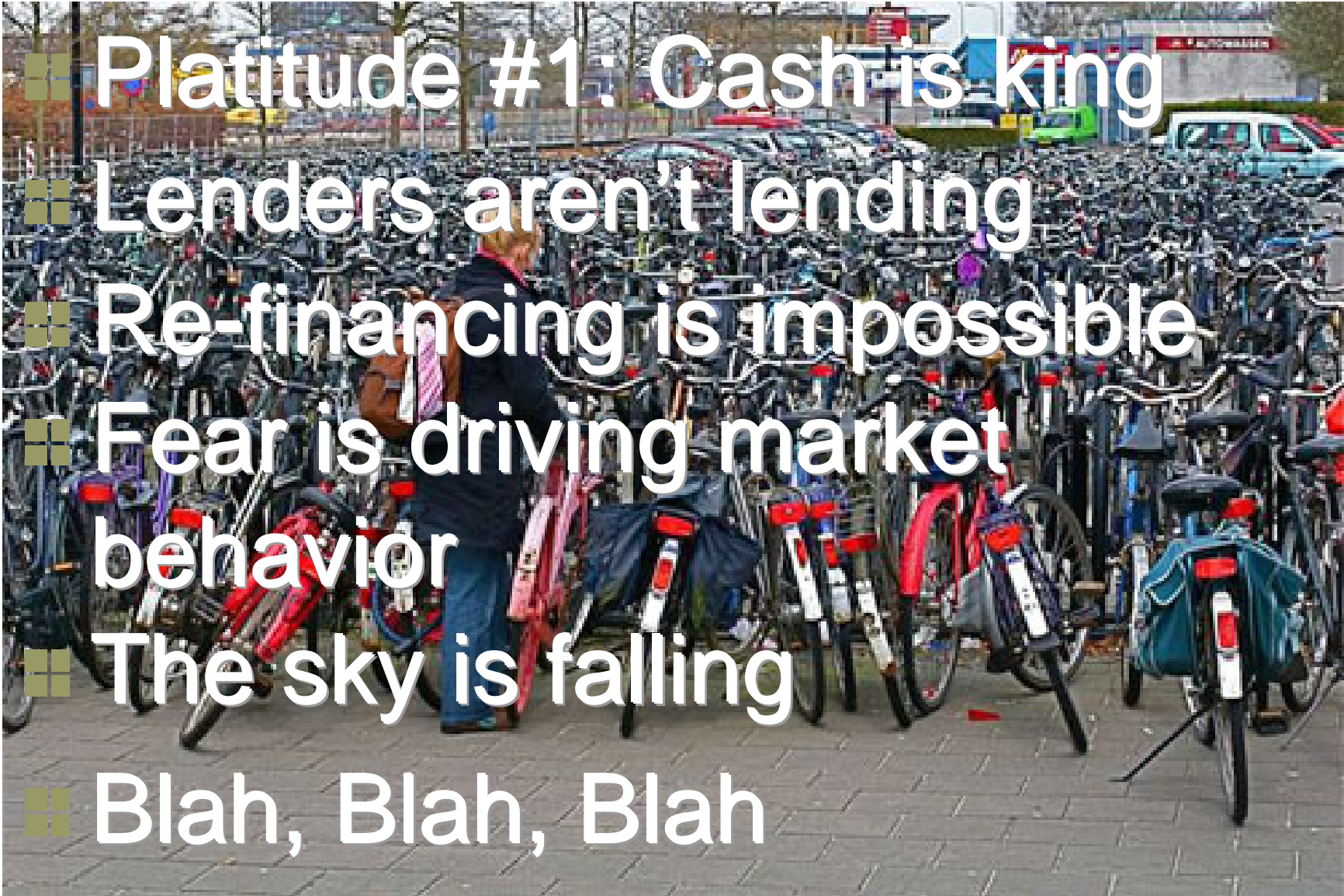
March 2009

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Why is the Credit Market So Tight?

- 
- Platitude #1: Cash is king
 - Lenders aren't lending
 - Re-financing is impossible
 - Fear is driving market behavior
 - The sky is falling
 - Blah, Blah, Blah

Why is the Credit Market So Tight?

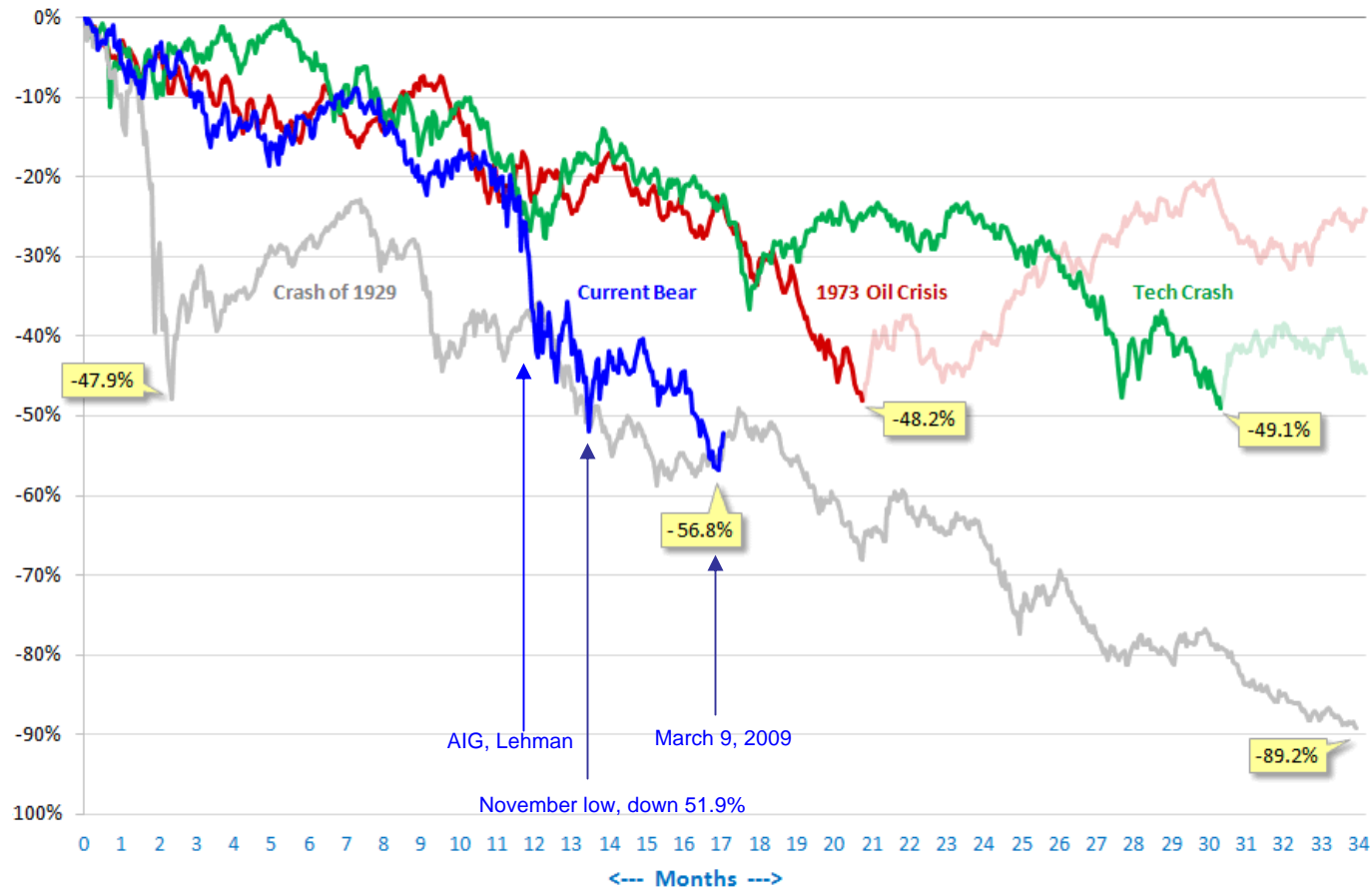
Two Themes

- **A: The element of surprise**
- **B: Systemic changes**

The Element of Surprise

Four Bad Bear Markets
Dow in 1929-1932; S&P 500 in 1973-74, 2000-02, 2007-09

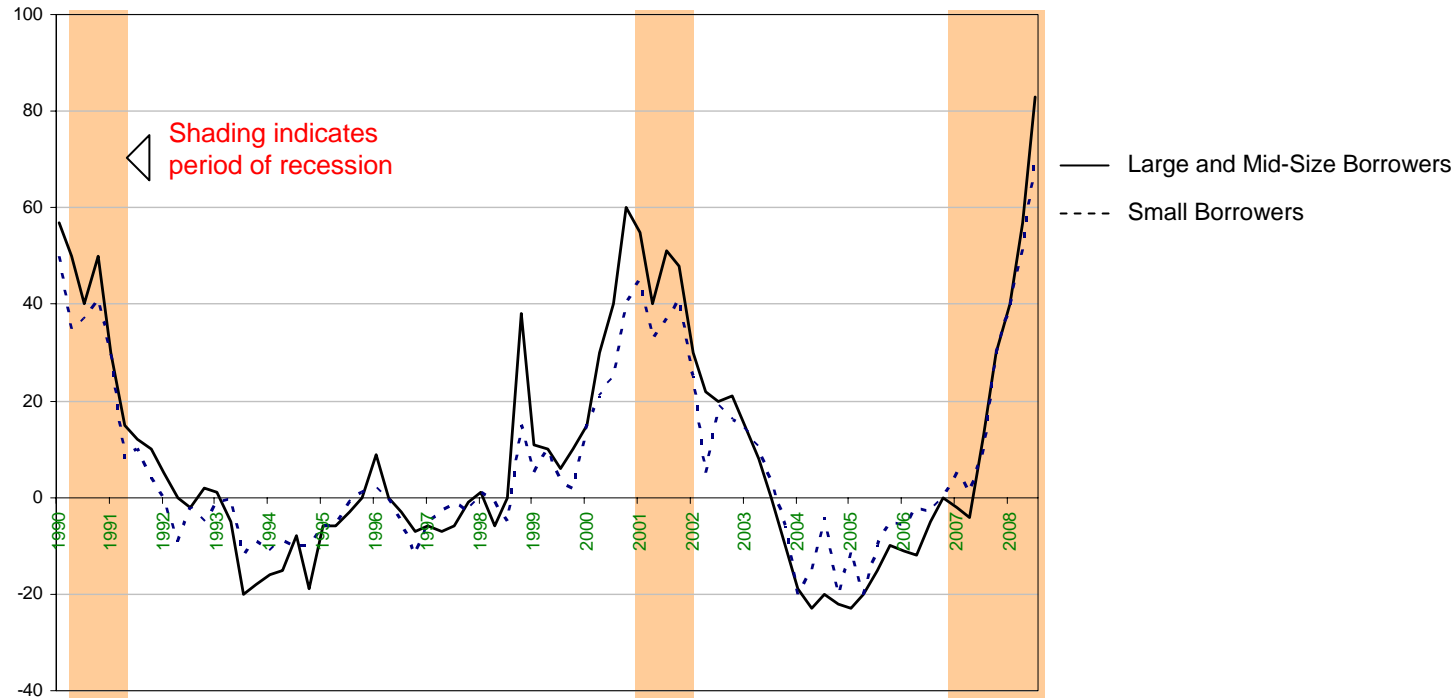
dshort.com
3/12/2009



Until the Lehman failure, the market trend looked similar to 1973, but since the leg down in September 2009, it looks like the 1929 market

The Element of Surprise

Net percentage of U.S. banks that indicate tightening credit standards on corporate loans



Source: Federal Reserve (published in the Wall Street Journal, November 4, 2008)

Lenders typically tighten prior to the onset of recession, but this time the tightening didn't begin until 4+ months into the recession

Tightening in 2008 was more significant and widespread than any time in the past 20 years.


- **Change 1: Fewer Lenders** in the market
- **Change 2: De-Leveraging:** Major lenders are looking to de-lever their balance sheets, lending less, and selling off loan participations and distressed assets.
- **Change 3: Commercial Paper:** A flight to safety resulted in short-term borrowing costs in the range of LIBOR +165bp and up in Q4. Total CP issuance plummeted, resulting in major disruptions to several finance companies.
- **Change 4: CLO Market:** Major finance companies raised capital in 2005, 2006 and 2007 by packaging loans into CLOs, which are no longer an option.
- **Change 5: Competition from the Secondary Market:** The glut of secondary market debt has driven up the implied interest rates on billions of dollars in corporate debt to 15% and higher.

1. Fewer Lenders in the Market
















2. De-Leveraging

- Finance companies dependent on “warehouse lines” (CIT, Newstar, CapitalSource) have seen advance rates curtailed from 4:1 (80%) to less than under 3:1 (current 65%-70%)
- The major investment banks, many of which were leveraged 25:1 to 60:1, are being forced to reduce leverage by 75%+
- For many firms including *CIT, Goldman Sachs, Morgan Stanley, GMAC* and others, further de-leveraging will be required by virtue of converting to a bank holding company



De-Leveraging means less capital in the market for lending, a higher cost of capital, and more restrictive underwriting requirements. This means less leverage for M&A, and lower valuations.

2. De-Leveraging = *Less Lending*

	TARP received in billions	4Q '08 loans in billions	Change from 3Q '08 loans
Bank of America	\$45	\$931.45	-1.2% 
Citigroup	45	694.50	-3.1 
J.P. Morgan Chase	25	744.90	-2.2 
U.S. Bancorp	6.6	168.13	 3.9%
SunTrust Banks	4.85	127.00	 0.2
Capital One	3.56	146.94	-0.3 
Regions Financial	3.5	97.42	-1.3 
Fifth Third Bancorp	3.41	85.60	-1.0 
BB&T	3.13	98.67	 2.1
KeyCorp	2.5	76.50	-0.3 
Comerica	2.25	50.51	-2.0 
Marshall & Ilsley	1.72	49.99	-0.9 
Huntington Bancshares	1.4	41.09	-0.2 
TOTAL	\$147.91	\$3,312.68	-1.37%

Source: WSJ analysis from company reports *The Wall Street Journal, January 26, 2009*

10 out of the 13 largest beneficiaries of the TARP reduced their outstanding loan balances in Q4 2008.

Just three of the banks reported growth in their loan portfolios: U.S. Bancorp, SunTrust Banks Inc. and BB&T Corp.

3. Commercial Paper Was Down 40%

- Total CP issuance, net of Fed investment, was down 40% in Q4 2008 from the 2007 peak.
- Pricing peaked in the range of L+165bp for 90-day CP, but now back down to L+33bp
- Commercial Paper outstanding Peaked at \$2.2 Trillion in Summer 2007
- By early January, CP outstanding was back to pre-Lehman levels ~ \$1.8 Trillion
- As of March 11, CP outstanding stood at \$1.48 Trillion, off 32% from the peak in 2007, but up 14% from the October low.

3. Dealing with Commercial Paper Shortage

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*Yields as of 09/15/2008 and may be reset weekly. Yield reflects the annual rate of return on your investment. It assumes that interest is accrued daily and posted monthly, and that there are no additional investments or redemptions. Current rates and yields are available at geinterestplus.com.


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General Electric, which historically relied on low-cost *Commercial Paper* to lend through GE Capital, has shifted to raising more capital through consumer cash deposits

4. CLO Market down by over 90%

- Major finance companies, unable to raise capital in the CLO market, have had to draw down warehouse lines, eating up capital that would otherwise have been available for direct lending by banks
- New CLO issuances were down by more than 90% in 2008



CLOs made it possible for smaller finance companies like NewStar, Gladstone, and Patriot to come into the market with just \$100M in equity, lend \$500M, and then sell the whole portfolio to the market and start again.

5. The Secondary Market

Sample of Benchmark Loans offering Yields upwards of 15%

Issuer	Coupon	Maturity	Ratings	Price	3-mo Price Change	YTM	Leverage
Select Medical TL	L+200	2/24/2012	BB - / Ba2	\$ 74.08	-\$ 19.75	15.00%	3.4x
HCA TLA	L+225	11/18/2012	BB / Ba3	\$ 78.44	-\$ 15.25	11.32%	3.5x
Vanguard Health TL	L+250	9/3/2011	B / Ba3	\$ 82.00	-\$ 14.50	12.64%	2.9x
Community Health TL	L+225	7/25/2014	BB / Ba3	\$ 68.64	-\$ 26.00	12.47%	4.1x
Goodyear TL 2nd lien	L+175	4/30/2014	BB/Ba1	\$ 63.33	-\$ 28.78	14.59%	1.5x
SunGard TL	L+200	2/28/2014	Ba3/BB	\$ 67.00	-\$ 26.33	13.50%	3.6x
Graphic Packaging	L+200	7/15/2014	Ba3/BB	\$ 61.72	-\$ 23.16	11.41%	2.0x
Celanese TLB	L+200	7/15/2014	Ba3/BB	\$ 63.00	-\$ 21.69	10.82%	2.5x
Georgia Pacific TL	L+200	7/15/2014	Ba3/BB	\$ 67.42	-\$ 17.46	11.09%	3.2x
Dollar General TLB1	L+275	7/6/2014	B1/B+	\$ 77.56	-\$ 15.53	10.04%	1.2x
First Data TL	L+275	9/24/2014	Ba3/NR	\$ 65.98	-\$ 26.29	13.75%	5.3x

\$20.5 Billion in revenue, Total Debt/EBITDA of just 2.9x Senior Term Loan (2nd Lien)

Sources: UBS, Markit

Note: Prices as of December 10, 2008

The glut of corporate debt trading in the secondary market makes it possible to buy existing secured debt in large cap companies with strong earnings at high yields. At 63 cents on the dollar, this loan yields 14.6%!

5. The Secondary Market

Sample of Private Loans Traded, offering Yields upwards of 56%

Issuer (<i>Names are Confidential</i>)	Bid Date	Revenue \$ MM	TTM EBITDA \$ MM	Senior debt \$ MM	Maturity	Loan Price	Mkt Leverage	YTM
Environmental Remediation Co	Nov 2008	\$360	\$33	\$136	Nov-11	\$51	2.1X	40%
Steel Coating Co	Oct 2008	\$160	\$20	\$81	Sep-10	\$53	2.1X	56%
Branded Consumer Electronics	Sept 2008	\$270	\$53	\$218	Sep-13	\$55	2.3X	28%
Branded OTC pharmaceuticals	Sept 2008	\$45	\$19	\$52	Jun-10	\$75	2.1X	45%
Radio & Outdoor advertising	Jan 2009	\$92	\$31	\$151	Nov-11	\$55	2.7X	30%

Source: Woodside Capital Partners

Middle-Market Loans, due to their smaller size and lack of independent credit ratings, are trading at even higher yields!

5. The Secondary Market

Brought to you in part by...

- Mark-to-market accounting, which makes “holding” distressed assets less attractive
- Staggering hedge fund redemptions such Blackstone (shutting down its \$1 billion distressed debt fund) and Fortress (which in November received \$2.6 billion)
- Forced redemptions due to fall-out from the Madoff fraud (\$50 billion), and bankruptcy filings including Lehman (\$639 billion) and Sigma (\$28 billion)
- Seizures, such as Highland Credit Strategies’ \$672 million fund
- CLOs exiting loan syndications where the loan is not performing

5. The Secondary Market

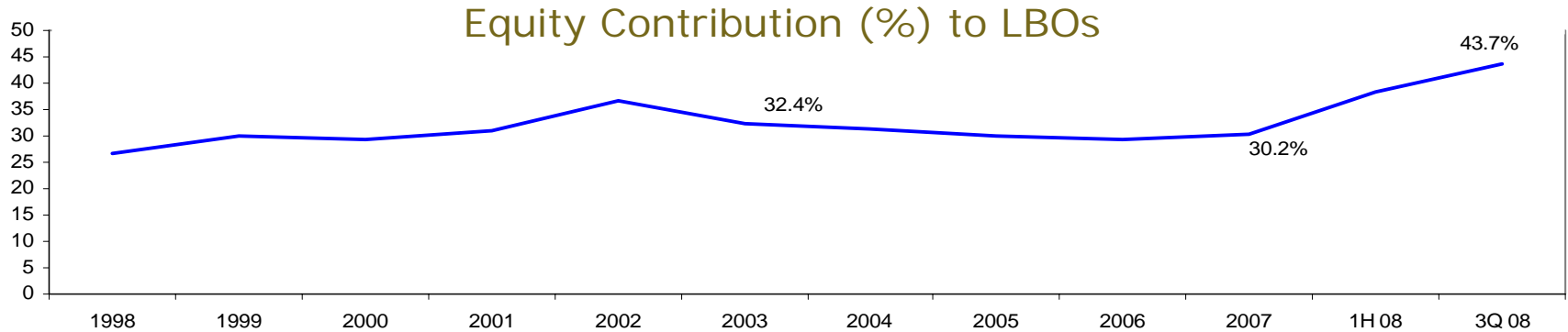
- “Performing bank loans with no near term probability of default, are trading at 71 cents on the dollar. It used to be that anything under 80 was considered ‘distressed’.”
Bank of America
- “We have put far more money to work in the secondary market since October than what we have deployed in new loans” *CapitalSource*
- “We have bought out several participations in club deals where we already had an interest, generally at a discount that gave us returns better than what we are getting in primary lending” *Wells Fargo*
- “We didn’t do syndications on the origination side, but we have several relationships at [Large Regional Banks] which have given us the opportunity to buy participations [in recent months] at a discount” *Danversbank*

Current Pricing Trends

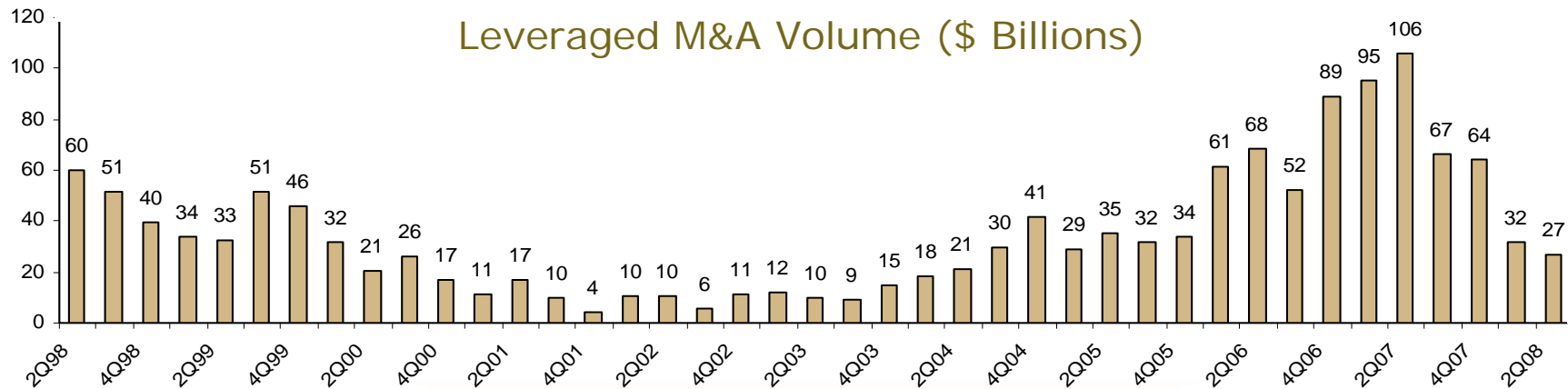
- ABL pricing, before up-front fees, is now at LIBOR+325bp to L+475bp (4.57%-6.07%) for loans of \$10M +
- Some local banks are still pricing at Prime+100bp to P+150bp (4.25% to 4.75%) for smaller ABL loans
- Points and Fees paid at closing are on the rise for commercial loans, 100bp on “healthy” and 200bp on “hairy” deals – driving up total cost of debt
- LIBOR floors of 300bp, absolute rate floors of 4.5% to 5.5%
- Cash flow loans are pricing at LIBOR+ 650 to L+900 before up-front fees
- Typical deals will now have three maintenance covenants (e.g. *EBITDA/total debt, fixed charges/EBITDA*)

- There is virtually no mezzanine lending going on today. Sub-debt providers, tasked with getting unlevered returns of 15%, can do better in the secondary market, buying senior secured paper at a discount
- There remains little 3rd Party DIP lending going on today, but that seems to be thawing out. CLOs are now looking to provide DIP financing on large bankruptcies with rated bonds
- Exit financing for companies in bankruptcy is nearly impossible to find
- Venture lending is “theoretically” available where companies are getting significant new money from new investors
- Major players like GE Capital, Madison, GMAC are essentially out of the market, Textron has shut down

Current M&A Climate



Source: Standard & Poor's LCD



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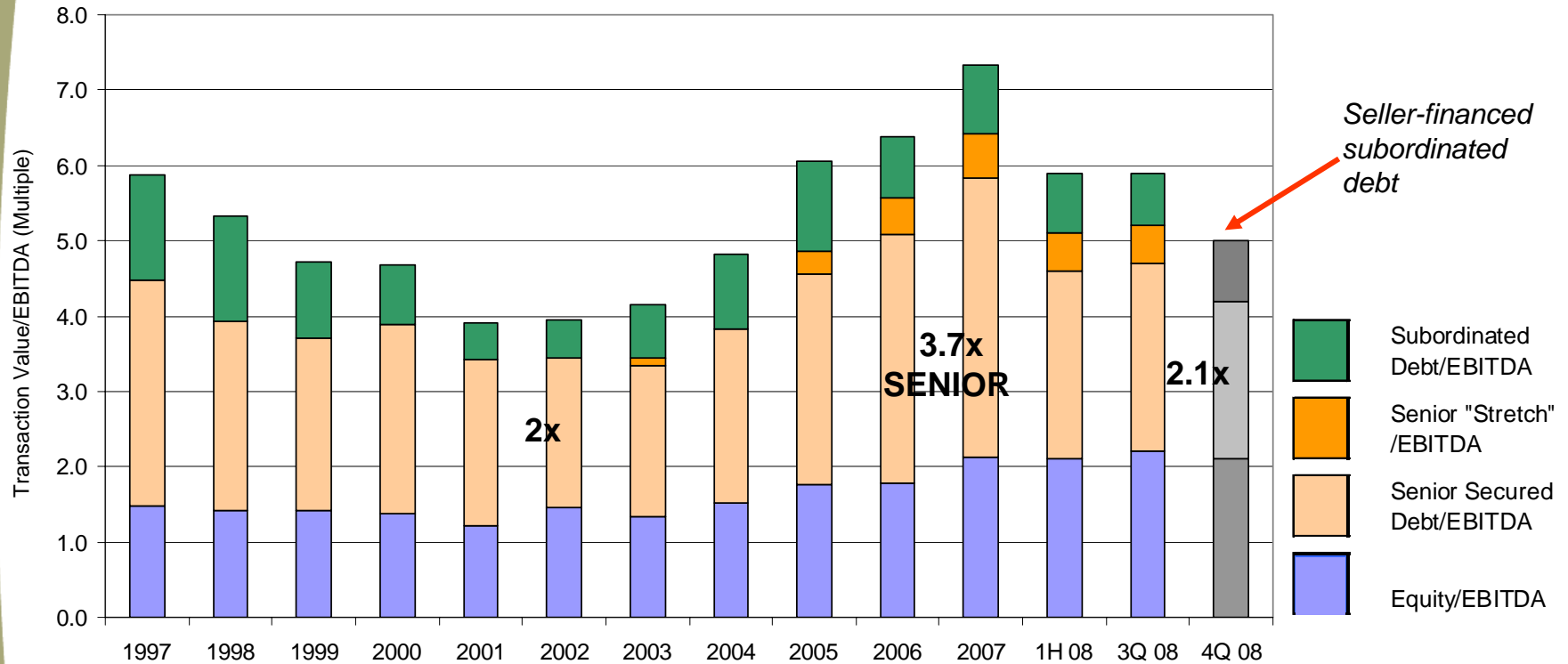
Leveraged M&A volume fell off in 2008, dropping to only \$27.1 billion in Q2, 74% lower than the Q2'07 all-time high of \$105.6 billion.

As equity contributions rise, values fall.

Current M&A Climate

Middle-Market LBO prices are back to 2003-2004 levels

Breakdown of Debt and Equity in LBOs (target EBITDA <\$10M)



Sources: Based on Mirus Survey (middle-market debt multiples) and Standard & Poors LCD (equity contribution)

Lower Middle-Market Valuations held up through early September close to 6x EBITDA, but have since dropped. Senior secured is now at 2.1x and there is no "stretch" or mezzanine debt available.

Expectations for 2009

- Venture Capital and PE sponsors will be doing “trriage” in order to focus on the best opportunities in their portfolio
- With DIP financing scarce, borrowers will be forced to work out more loans with their lenders to avoid uncertainty of Chapter 11
- FASB announced in December that it is reviewing Mark-to-Market accounting for mortgage-backed securities, commercial-backed and certain other structured securities.
- Greater regulation of financial institutions, including lenders, hedge funds, rating agencies, insurance companies, etc.
- De-leveraging means a persistent state of tighter credit and higher borrowing costs, resulting in slower growth and a near-term decline in M&A volume
- CLOs and Hedge Fund assets will mature and create new demand for credit, without supply to match

Take Aways

- Commercial loan default rates may reach 10% this quarter, and 15%+ by year-end.
- Corporate borrowers should take special care to maintain a cash cushion and avoid operating losses in 2009
- Early stage companies need to prepare to survive through late 2010 without new funding
- Companies that see the potential for distress (cash shortfall, covenant default) in 2009 need to be proactive with expense management and communication with lenders
- It's a buyer's market. Companies with strong balance sheets should be taking advantage of this opportunity.
- Hostile takeovers will again be in vogue in 2009, as strategic acquirers will look to buy the debt of target companies when they can't come to terms on price