

Where are the bright spots?

London, 12 January 2012, by Steve Curry & Mike Nawas

After a tumultuous second half of 2011 in the financial markets, on the face of it, 2012 does not appear to hold much to cheer about, particularly in Europe. What will happen to the Euro? Where will the next sovereign downgrade occur? How much more equity do European banks need in order to restore confidence? There are no quick fixes to this uncertainty. However, as Benjamin Disraeli once said “there is no education like adversity”. In this Market Insight we ask what we can learn from these very volatile markets and where the bright spots might be in 2012.

Corporates... the light among much darkness

Corporates will stand out as a zone of relative stability and growth for 2012. We expect Sovereigns and Financials to be mired in uncertainty until the markets embrace the policy responses aimed at stabilising the macro-environment and even after that they will still have to bear the burden of the required austerity measures. Although the uncertain global macro economic environment is part of the backdrop for all sectors, Corporates are, relatively speaking, generally in good health. They have conserved cash as much as possible and are not facing the seismic shifts in regulation which are expected to change the face of financial institutions. Of course, that is a large generalisation and not all corporate sectors will fare the same. For example, the retail sector looks set for a tough time in 2012 as job losses, wage freezes, tax increases and inflation will hit real disposable incomes in almost all European countries. On the whole, though, Corporates have become much more able to and also much more adept at adjusting to frequent changes in the economic fortunes in their sectors than, for example, financial institutions have. As a result, they have been quicker to get their houses in order and reshape their businesses to the environment around them. They have acted swiftly

to deleverage and use retained profits to cut or buyback debt.

The “essential” industries such as energy, agriculture, commodities, healthcare and food retail will continue to fare well this year. They are a safe haven for both debt and equity investors alike. It is telling that in some countries, Corporates in these essential sectors are seen by the financial markets as a better risk profile than the Sovereign, evidenced by the yield each has to pay on their borrowings (see Table 1).

Table 1: Sovereign v Corporate Borrowing Costs

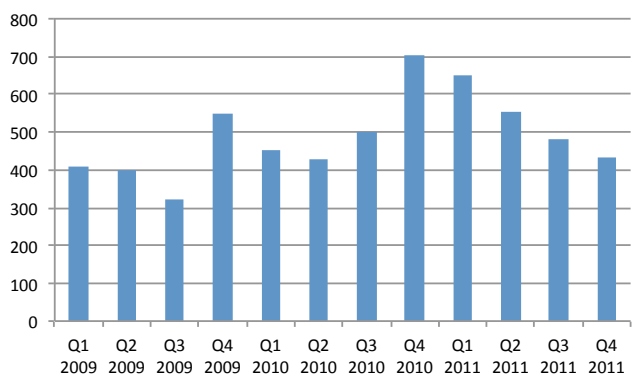
Country	Borrower	Debt Instrument	Current Yield
Portugal	Sovereign	5yr composite bond	15.90%
Portugal	EDP	2016 Euro bond	8.99%
Italy	Sovereign	10yr composite bond	6.92%
Italy	Enel	2022 Euro bond	6.19%
France	Sovereign	5yr composite bond	1.97%
France	Sanofi	2016 Euro bond	1.90%

Sources: Bloomberg, Financial Times

Against such a benchmark, what has been disappointing in corporate land, is the level of M&A

activity. According to Thomson Reuters, although Global M&A volumes were up slightly last year compared with 2010, the trend in activity is downward: the second half of 2011 saw a 24% decline in activity compared the first half. This reduction in M&A volumes in the second half of last year would undoubtedly, in part, have been due to the volatility in financial markets, Euro crisis, sovereign crises elsewhere, the macro economic climate, concerns about access to funding and a general lack of confidence among business leaders (more on this later).

Figure 1: Global M&A Volumes (\$m)



Sources: Thomson Reuters, MergerMarket

Many corporates have however managed to ride out the storms very well for a significant period of time now and we think that for the bold, this will be a point in the cycle where Corporates could make strategically important acquisitions at relatively attractive prices. In sectors which have been relatively stable, the question that Corporates need to ask themselves is does the sovereign debt / Euro crisis really impact them? If the answer is: “not materially”, then maybe holding off on an acquisition until the broader global economy has recovered, and prices have kicked up, is not such a smart strategy.

Of course, unless a corporate is awash with so much cash that it could fund an acquisition without the need for borrowing, access to debt would be a worry. We are, however, quite bullish on the availability of debt for large, well-recognised Corporates. Our arguments are:

- Large, well known corporates, particularly in essential industries, have not experienced major difficulties in raising or refinancing bank debt

- Corporates with a core number of relationship banks will continue to get solid support from their house banks even when liquidity in the bank sector is constrained – in fact, banks are conserving capital for this type of client as it remains core business (especially for banks with domestic lending targets)
- The public capital markets have continued to essentially remain open for well known corporate borrowers despite the financial turmoil
- The private placement market is an option for some corporate borrowers too and we have seen increasing use of it by European Corporates last year. Importantly, as a signal for 2012, there has already been evidence of two European private placement transactions launching this year (\$325m for Thames Water and \$100m for Liberty Living (UK student accommodation))
- The cost of debt remains very low as a result of low interest rates

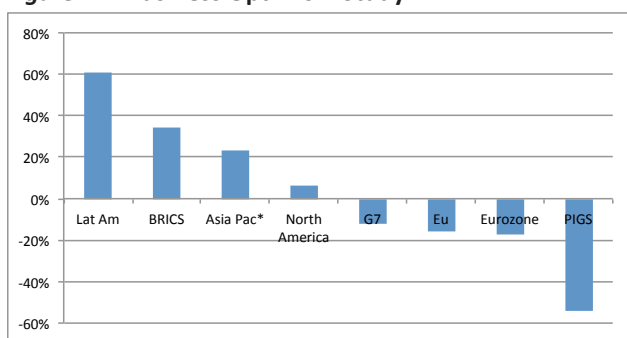
While on the subject of the availability of senior debt, we recognise that the bank market is less deep than it was a few years ago. We therefore continue to believe that there is room for a larger number of senior debt funds to emerge. There is some evidence that there is further momentum here too and we see this as another possible bright spot for 2012. Evidence of this is CVC Capital Partners’ and Apidos Capital Management’s recent agreement to merge their senior debt lending businesses to create a transatlantic lender. This followed Blackstone’s acquisition of Harbourmaster, taking its corporate lending book to over £9bn.

Is the gap between emerging and developed markets closer than we thought?

The emerging economies in Asia, Latin America and Eastern Europe (excluding Eurozone countries) continue to offer opportunity in 2012. Firstly, confidence among businesses in those jurisdictions is much higher than in Europe or North America. A recent study by Grant Thornton showed that the net percentage of businesses indicating optimism less those indicating pes-

simism for 2012 was 61%, 34% and 23% of businesses surveyed in Latin America, BRICS and Asia respectively. In North America this was 6% and in the Eurozone the figure was a gloomy -16%. For businesses in the emerging markets the general level of optimism/confidence is a likely driver of growth in private sector investment volumes with spill-over into the broader economy. And although a recession in Europe would lead to depressed exports by emerging economies into Europe, for the larger emerging economies there is ample room for domestic growth to compensate for loss of exports.

Figure 2: Business Optimism Study



Source: Grant Thornton

Given the rapid changes in global economic dynamics where, for the last decade time and again many emerging markets have driven economic growth globally, it is interesting to reflect on some fundamentals of emerging market investment risk. Traditionally, those risks specifically identified as being considerably higher in emerging markets are:

- Currency convertibility risk
- Political risk
- Regulatory risk
- Legal risk
- Expropriation risk

The question we raise, when looking at the larger emerging markets such as Brazil, India, China, Russia, etc (i.e. excluding the more exotic locations), is: are the risks traditionally associated with emerging economies really that different from Europe today? Until now, most bankers and investors would have suggested that there is a meaningful difference. However, consider the information in the following table:

Risk	Question	Bishopsfield Capital Partners' view
Currency risk	Are the risks associated with the Euro today less than emerging market currencies?	Possibly, but a much closer call than ever before
Political risk	Are the risks associated with political intervention today less in Europe than in emerging markets?	Probably not
Regulatory risk	Is there a higher risk that emerging market regulators will impose more stringent regulation than in Europe?	Probably not
Legal risk	Are the legal and tax regimes more predictable in Europe than in emerging markets?	Possibly
Expropriation risk	Is it likely that financial assets in emerging markets are more likely to be (semi-voluntarily or otherwise) expropriated than in Europe?	Probably not

In our opinion, the recent Euro and Eurozone issues have challenged the conventional thinking about the risk profile of the larger emerging markets compared with developed markets, particularly when compared to Europe. We are not calling for Europe to be labelled as an emerging market but do argue that the larger emerging markets' risk profile is not so far removed from developed markets, once again underscoring the opportunity they provide for investors given their stronger macro economic picture at present.

Portfolio, or not to portfolio? ...

That is the question

The notion that diversification of risk is an effective mitigant to credit investors has been a theme long championed in the Structured Finance markets. One comparison in Europe might be prime European RMBS versus the bulk of European CMBS. The former normally containing literally thousands of individual mortgage loans versus the latter normally containing very few underlying loans/commercial properties. If the credit quality of these two examples were measured by the relative number and extent of rating agency downgrades, then RMBS with its greater granularity, has offered a better credit risk to investors.

We agree that a portfolio approach/asset allocation can be an effective risk management tool. However, the value of diversification of risk hinges on the extent of correlation between each of the underlying exposures. And often the degree of correlation is underestimated, as was painfully evidenced in the banking crisis of 2008 when asset classes showed far greater correlation to shocks in other asset classes than most banks and investors had previously assumed.

Consequently, we are seeing a trend, even for those institutions and investors which do apply a portfolio approach both at a macro level and within asset classes, to pay far greater attention to the individual assets which make up a portfolio than there has been in the past. We think this is a good trend, as it overlays, to a greater extent than previously, a second layer of risk analysis on top of a portfolio risk analysis. This enhanced focus on individual risk analysis will then, in turn, help to restore confidence of investors who lend to or invest in banks and financial institutions (which are portfolios of risk too) of the likely stability of their investment return.

In our view, this will be an especially important theme for the year ahead. It is not that packaging of assets has had its day, but rather that investors will be more discerning and seek to cherry pick assets which they know, understand and like and anything which does not “fit” will be “rejected”. So, for borrowers, the consequence is that they will have to accept a deeper scrutiny of their individual credit risk, and accept that not all investors will be willing to allocate the effort that goes with such scrutiny to as many borrowers as they did before: i.e. there will be a further reversion to concepts of “house banks” and “investor followings” rather than broad distribution. The importance of an ongoing relationship between borrowers and investors is on the increase.

In our view, this is going to be important in the year ahead in two areas in particular. Firstly, banks will need to continue to deleverage and to have any meaningful impact they will have to sell decent sized portfolios. The key challenge for the banks is to:

- Ensure they aren't left with the least attractive assets in their portfolio, which could hamper investor confidence in their institution's remaining risk profile
- Ensure they find sufficient investors with appetite in the asset types they hold, so that they are not held hostage by a limited number of buyers
- Execute a sale at a price which is acceptable to buyers but doesn't constitute such a loss on sale for the bank that its capital base is once again put into question

This is not an easy task in an environment where investors will be ever more choosy and there are many more sellers than buyers.

Secondly, in commercial real estate, where as a consequence of more and more loans reaching their maturity dates the need for refinancing will be even more of a challenge than last year, preoccupying even the strongest borrowers. The quality of individual assets will therefore be a major driver in successfully attracting financing. The depth of the market for senior debt to finance commercial real estate is very thin and this is likely to mean that for many borrowers part of their portfolio will be financeable via traditional means but part of it may not. In our opinion, there will be an even greater need for those either seeking financing or selling their assets to identify:

- Whether a portfolio needs to be split into manageable pieces in order to make it attractive to specific lenders
- If a split is necessary, which type of buyer or financier is most suited to which part of the portfolio
- If, even after splitting, there is a need for creating horizontal tranches to cater to the return needs of different types of lenders
- Whether there are any elements of the portfolio which are unsellable at any price (and which will therefore need to be retained) and what the implications of this are. For example, leading to a need to raise further equity

Self help... the way to regulators' and policy-makers' hearts?

Another bright spot on the horizon is that 2012 is likely to be the year in which we will see the materialisation of some of the industry initiatives designed to re-energise and strengthen the European secured capital markets. An initiative close to our heart is the Prime Collateralised Securities ("PCS") project, being spearheaded jointly by the European Financial Services Roundtable (EFR) and Association for Financial Markets in Europe (AFME). The PCS initiative is seeking to reinforce asset backed securities as a sustainable investment and funding tool for both investors and issuers with the aim of improving market resilience in Europe, promote growth of the real economy and maintain high standards of quality, transparency, simplicity and – as the PCS market grows – liquidity. The intention is to create a label which can be applied to prime securitisations which meet a stringent set of eligibility criteria. Ultimately, the securitisation industry hopes that PCS will be an additional step in evidencing to regulators and policy-makers that the prime European securitisations under its label are all high quality credit instruments that have an important role in creating liquidity and therefore can promote growth of the real economy.

The acid test of the effectiveness of PCS is likely to be whether policy-makers are persuaded that bonds which have a PCS label merit a less harsh capital treatment under Basel III and Solvency II than currently is muted and also might be capable of being included in liquidity buffers. Regulators and policy-makers seem to have encouraged the PCS initiative to continue but have consistently said that they would want to see its impact before drawing any conclusions. To us, this seems to be a fair position to take. The bottom line for the securitisation industry is therefore that they must get PCS up and running if there is to be any hope of more favourable regulatory treatment.

As advisers to EFR, AFME and the other institutions supporting and working on PCS, Bishopsfield Capital Partners might have a more rosy perspective than some, but whilst there is still work to be done, we are optimistic that 2012 will be the year in which PCS is going to be launched on a pan-European basis. In our view, anything which helps to stabilise and enhance access to liquidity by banks is good for the overall functioning of the debt markets, and thereby also for the broader economy in Europe.

Conclusion

Clearly 2012 will be a challenging year on many fronts and uncertainty is unlikely to dissipate quickly. Of course it is possible to take the view that it is therefore best to stand on the sidelines and wait for better times. But as hopes for a V-shaped recovery from the credit crisis have evaporated, biding one's time could entail a very long period of investment standstill. We'd rather seek out the bright spots, of which there are some, and look to build from those. We have highlighted some areas that we think investors should consider, and we'll be doing more than watching that space.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you
info@bishopsfieldcapital.com.

Disclaimer

This document is for informational purposes only. Although endorsed as market update by Bishopsfield Capital Partners Ltd, it expresses the author's opinion only. Neither Bishopsfield Capital Partners, nor the author, accept any legal responsibility or liability of whatever nature in relation to the information presented in this document. Statements, opinions, market information and views on market direction are as of the date of this document and can be changed at any time without prior notice. In no way should this document be construed by a reader as a financial promotion to buy, sell, issue or otherwise trade in any financial instrument. This document, whether in whole or in part, may not be copied or distributed by anyone other than Bishopsfield Capital Partners.

Bishopsfield Capital Partners Ltd is authorised and regulated by the Financial Services Authority.