Morgan Stanley

MORGAN STANLEY RESEARCH
ASIA/PACIFIC

Morgan Stanley Australia Limited+
Gerard Minack
Gerard.Minack@morganstanley.com
+61 2 9770 1529

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Downunder Daily

Back in the Kennel

"Bankers are like dogs." Not my view, that's from Guy Hands, CEO of buy-out firm Terra Firma Capital Partners. Mr. Hands continues: "They hunt in a pack and go into a feeding frenzy. When hit, they whimper, and hide in their baskets. The bankers have been hit very hard, and they're not going to come out of their baskets." Banishing bankers to their baskets has a number of implications:

First, without finance, the wave of merger & acquisition activity has collapsed (Exhibit 1). The most recent three months may exaggerate the extent of the decline, but corporate activity is unlikely to return to the halcyon pace of the first half.

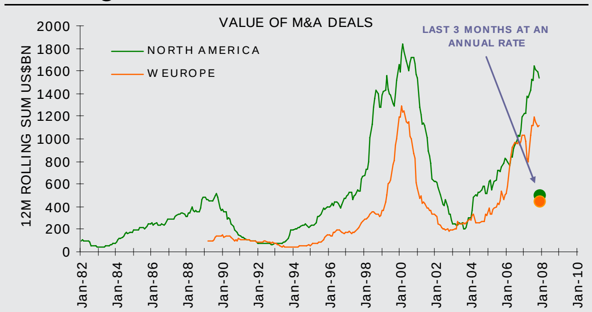
Second, banker caution means that the deals that do get done are likely to be more conservatively funded. Exhibit 2 shows a range of finance metrics for both the average LBO transactions and 'outer-edge' deals (the most aggressive 20% of deals done in the period). Average leverage (total debt/EBITDA) for the outer-edge has fallen from 9.3 times in the three months to mid-August to 8.0 times in the last three months.

Third, falling deal flow and less aggressive financing will reduce the prospect of a material PE re-rating in developed equity markets. (Reduced upside potential for equity PEs was one of the reasons why our European strategy team decided that the risk-reward now favors a neutral position in equities.)

Fourth, the turn in banking sentiment comes as the first signs of deteriorating credit performance appear. Exhibit 3 shows an uptick, albeit from very low levels, in the number of distressed corporate bonds and loans.

Exhibit 1

The Dog Lost Its Bite?



Source: DataStream; Morgan Stanley Research

Exhibit 2

Less Aggressive Pricing

Outer-Edge Credit Stats

	3 Months-Ending 11/08/07		3 Months-Ending 08/10/07	
	Most Aggressive	Average	Most Aggressive	Average
Large Corporate				
First-Lien Debt/EBITDA	5.3x	3.6x	5.6x	3.7x
Senior Debt/EBITDA	7.0x	4.7x	7.8x	4.9x
Total Debt/EBITDA	7.8x	5.2x	8.3x	5.4x
Cash Interest Coverage	1.4x	2.6x	1.5x	2.5x
(EBITDA-Capex)/Interest	1.0x	2.2x	0.9x	1.8x
Large Corporate LBOs				
First-Lien Debt/EBITDA	5.3x	4.1x	6.3x	4.2x
Senior Debt/EBITDA	7.0x	5.2x	8.9x	5.7x
Total Debt/EBITDA	8.0x	6.1x	9.3x	6.2x
Cash Interest Coverage	1.3x	2.0x	1.4x	2.1x
(EBITDA-Capex)/Interest	0.9x	1.5x	0.7x	1.3x

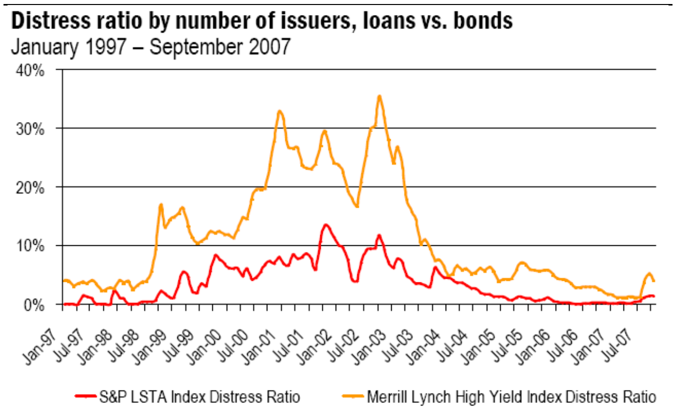
Outer Edge represents highest 20% of observations for leverage ratios and lowest 20% of observations for coverage ratios

Source: S&P LCD; Morgan Stanley Research

Fifth, reduced corporate activity will presumably also affect the supply-demand balance for equities. In the US, for example, net equity on issue has been contracting through the past 18 months (Exhibit 4). For now, however, corporate buy-backs remain high, so issuance may continue to fall (at a less-rapid pace) in the near term.

Exhibit 3

A Distressing Uptick

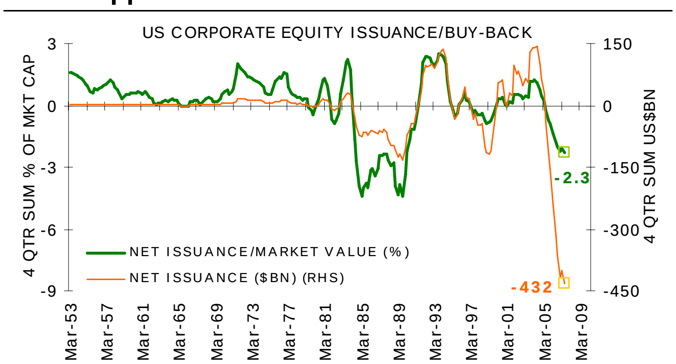


Source: S&P LCD; Morgan Stanley

As an aside, a fall in M&A-related demand for equities may tighten the screws on household finances. As I've noted before, the US household sector has partly funded its cash-flow deficit by selling stocks. If M&A falls, then that avenue of household-sector financing may shrink.

Exhibit 4

Less Support for Stocks

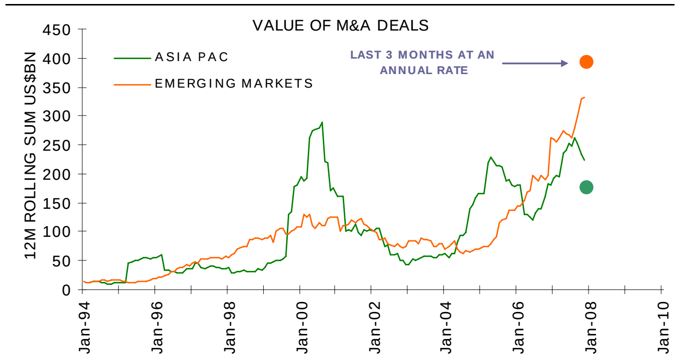


Source: Federal Reserve; Morgan Stanley Research

Finally, it's worth noting that while Western-market M&A has slowed sharply, this is not the case in emerging markets. As Exhibit 5 shows, the level of M&A activity in emerging markets has accelerated over the past three months. This, for now, clearly seems to be one area of successful decoupling.

Exhibit 5

Another Playpen for the Dogs?



Source: DataStream, Morgan Stanley Research

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(as of October 31, 2007)

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200