

December 10, 2007

Downunder Daily

One Cycle That's Turned

The credit crisis is asphyxiating corporate activity, at least in developed markets. M&A volumes have fallen sharply over the past three months (Exhibit 1). This has a few implications, in my view:

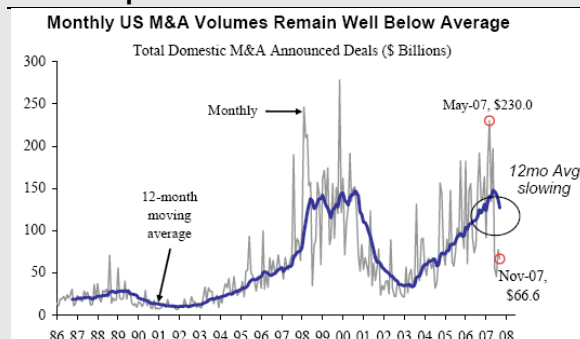
First, the turn in the M&A cycle reduces one support for equities. Moreover, while stock-based bids may continue, M&A is bringing less fresh cash to the market. That's because the cash component had relied on LBO financing, and LBO volumes have collapsed (Exhibit 2). This LBO cycle had dwarfed its predecessors and, relative to market capitalization, had surpassed the grand-daddy of LBO booms, the late 1980s. But now, without LBO-funded cash, M&A is increasingly just investors swapping paper for paper.

Second, the change in credit conditions has removed the arbitrage that made corporate activity so attractive. In other words, quite apart from the reluctance of bankers to fund these deals, debt-funded deals now look far less attractive. Exhibit 3 shows a rough approximation of the arbitrage that underpinned the LBO boom: it shows the average cost on leveraged loans versus the EBITDA yield on the acquired company. In 2004 that spread was close to 1000 basis points; now it has almost vanished. Without that spread, it's hard to make any deal work.

Third, the turn in the M&A/LBO cycle is one example of what I think is a bigger picture theme for the financial sector: what's changed for financials is not just the write-downs on their inventory of financial assets, but we are also witnessing a trend change in the outlook for recurrent earnings. As far as M&A is concerned, we are unlikely to see the lucrative market conditions of the past few years return for many years. In other words, clearing out dud assets will not return business to 'normal' conditions.

Exhibit 1

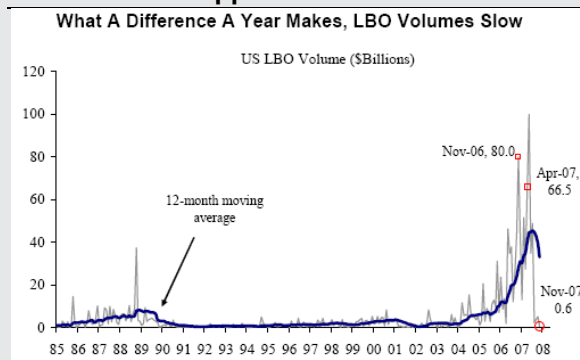
M&A Drops...



Source: Abhijit Chakraborti, *In The Flow*, November 2007; Thompson Financial; Morgan Stanley Research

Exhibit 2

...As LBOs Disappear



Source: Source: Abhijit Chakraborti, *In The Flow*, November 2007; Thompson Financial; Morgan Stanley Research

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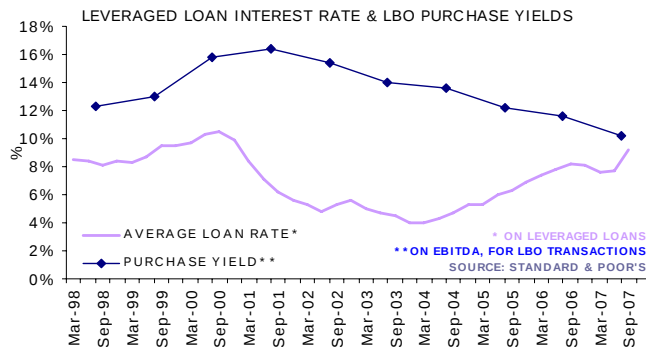
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Strategy and Economics

Fourth, while M&A has fallen, corporates remain willing to self-administer additional leverage. In particular, buy-backs have increased sharply over the past few months (Exhibit 4), even as M&A activity has faded.

Exhibit 3 The Spread Disappears

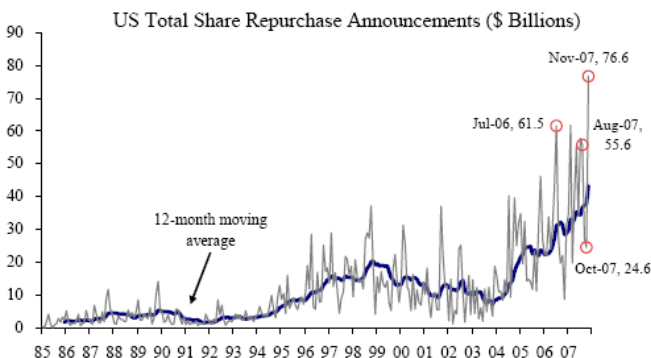


Source: Standard & Poor's LCD; Morgan Stanley

This continues the shift seen over the past 2-3 years: corporates managing their balance sheets to enhance equity holders' returns, in contrast to the 3-4 years before when they were managing for their debt holders. The Fed's flow of funds report shows what that means for corporate financing flows: equity issuance is contracting as credit use rises (Exhibit 5). (To be fair, the flow of funds is up until September, so it does reflect the more buoyant corporate activity of the first half.)

Exhibit 4 Buy-backs Get Stronger

Announced Buybacks Explode In November

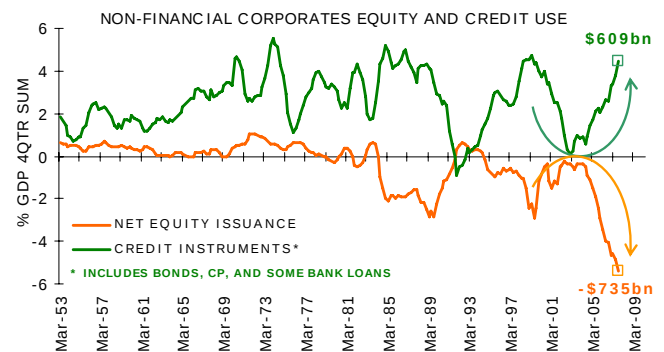


Source: Abhijit Chakrabarti, *In The Flow*, November 2007; Thompson Financial; Morgan Stanley Research

Buy-backs continue even as growth in free cash accelerates. As Greg Peters, head of our US credit team has noted, free cash flow in the 233 non-financial

companies covered by the credit team is almost down to zero (Exhibit 6).

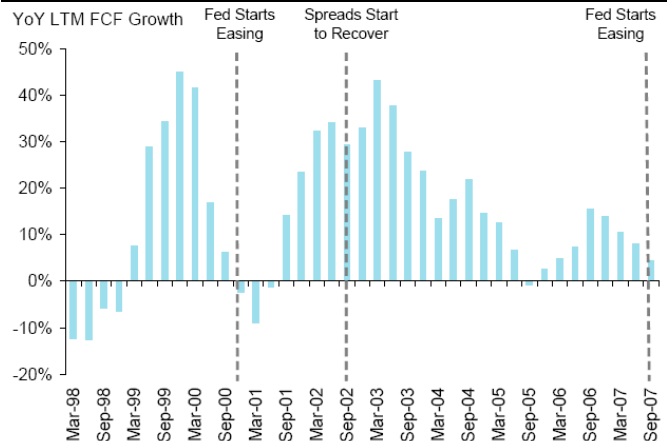
Exhibit 5 Corporates Re-lever



Source: Federal Reserve; Morgan Stanley Research

Finally, it's still true that on most credit metrics the corporate sector looks far less stretched than it was at the peak of the prior cycle. (Although, as Greg notes, investment spending was very high in the last cycle, which gave corporates the 'easy' option of capex cut-backs to improve cash flow when economic conditions turned; now capex is far lower so that option will be harder to use.) As I've often noted, the epicenter of credit problems in the next downturn will be households and the financial sector itself. But there are now signs, in my view, that the corporate sector will face not insignificant collateral damage if growth rolls over.

Exhibit 6 Free Cash Growth Almost Negative



Source: Greg Peters, *Free Cash Fading*, 30 November, Morgan Stanley Research

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(as of November 30, 2007)

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