

Thesis Market Commentary

June 2011

“If you don’t have integrity, you have nothing. You can’t buy it. You can have all the money in the world, but if you are not a moral and ethical person, you really have nothing”

Wise words indeed, and who can possibly disagree with this philosophy. However, to which eminent moral guardian of society do you think they are attributed? No, not the Archbishop of Canterbury, Nelson Mandela or Mother Teresa! Nor even Marx, Keynes or Bevan. It is in fact a quote by **Henry Kravis**, co-founder of Kohlberg Kravis Roberts* (aka KKR).

The financial meltdown in one of the UK’s largest care home providers, Southern Cross, and the involvement of another major private equity player, Blackstone (total assets of \$168 billion), has turned the spotlight on an area of the investment world which has traditionally tried to keep a very low profile as far as the wider media are concerned. Perhaps not surprisingly therefore that the average private investor’s knowledge of this area is generally fairly cursory, restricted primarily to the largest UK takeovers and/or subsequent flotations, such as Rank Hovis McDougall, Woolworths, Boots, HMV and EMI.

So are they the “unacceptable face of capitalism” (to quote Edward Heath’s infamous denunciation of the mining baron ‘Tiny’ Rowland) and the spawn of the devil, or maybe white knights, riding to the rescue of undercapitalised or poorly managed companies? Judge for yourselves based on this potted history.

Background

The first big investors in privately held companies were probably the uber-rich American dynasties like the Vanderbilts, Rockefellers and Warburgs. This was not however the reason why all the big private equity firms originated in the US. Unlike the UK’s (private and public) banks, their US counterparts were unable to invest in companies due to the structural restrictions imposed under the Glass-Steagall Act and other regulations in the 1930s. This situation remained until the establishment of investment banks half a century later - by which time the private equity and venture capitalist firms had already made their mark with a series of high profile (and occasionally controversial) takeovers and leveraged buy outs (LBOs). Unlike World War II the Europeans were latecomers to the fray, and deal sizes therefore less spectacular.

Many private equity firms were structured as limited partnerships to hold investments in which the investment professionals served as general partner and the investors, who were passive limited partners, put up the capital. The compensation structure, still in use today, usually involved the limited partners paying an annual management fee of 1-2% and carried interest typically representing up to 20% of the profits of the partnership.

The original intention was to help finance smaller new or developing companies, although activity at the peak was heavily focused on the electronic, medical and data-processing technology sectors. Companies benefitting included Apple, Amazon, E-bay, Cisco, Yahoo, Google and Microsoft.

Private equity offered founders an assured exit route (particularly where flotation was not economic or viable and selling to a competitor unthinkable!). A new dimension was added with the US Sarbanes Oxley legislation, passed in 2002, following a series of corporate scandals at the likes of Enron and WorldCom. With the burden of heavier compliance and reporting requirements, and greater transparency, the appeal of moving to the relative anonymity and softer regulation of private ownership became overpowering for many corporate boards and paved the way for more friendly takeovers.

Angels or devils?

On the side of the angels are:

- The injection of venture capital has been a major factor in the successful establishment of many of today’s household names (not to mention the taxes and employment they can generate)
- Private equity isn’t just about financing embryonic megastars. It also involves buying into larger and longer established

(often underperforming) companies, then restructuring management as well as the balance sheet and endeavouring to revitalise their fortunes

- The need to service and repay the debts arising from a bid will usually force management to dispose of unprofitable or low margin businesses, cut back on wasteful expenditure and uneconomic acquisitions and thus boost operating efficiency - and shareholder value.

And riding with the devils are:

- One of the key reasons behind the remarkable growth (and profitability) of the private equity and venture capital sector - and the cause of most adverse publicity - is the way that many of the deals are financed and structured. This often involves the issue of unsecured high coupon debt, colloquially known as junk bonds, and/or financing a bid with bank or institutional loans where the property assets in the target company are ‘used’ as collateral. Hence minimal equity is actually injected. Typically a bid would be made on a ratio of 90% debt to 10% equity. Some more notorious bids were made with 100% debt

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*KKR are one of the original and largest US private equity groups - part of the infamous trio behind the (then) record \$33 billion leveraged buyout (LBO) of the US healthcare conglomerate HCA Inc. five years ago.

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■ A good analogy is at the height of the UK property boom, when it was possible to borrow 100% of the cost of a house (and sometimes more!) based on a multiple of over 5 times earnings (or merely a credit card limit in the case of some unemployed US borrowers!). With house prices rising by around 15%- 20% per annum the attraction for first time buyers, buy to let investors or those just looking to trade up was pretty compelling

■ Bids or large stakebuilding can circumvent the board of directors by means of a tender offer direct to shareholders, usually at a significant premium

■ When bids fail any junk bonds issued usually become valueless

■ For some of the acquired companies (particularly those in cyclical industries) servicing the legacy of debt repayments suffocated cash flow and led to bankruptcy.



Summer's here - but no one's partying!

Having recovered the loss in output experienced during the recession of 2009 and 2010, information from a number of different sources points to a softening in the pace of US economic growth in 2011. Not for the first time, signs of a possible soft patch in economic activity are causing equity investors to question whether growth will be maintained in the coming quarters and if not, how this is likely to impact on equity prices.

In the UK, latest indicators also point to a weakening in the current quarter. But as in the US, this is largely the result of higher inflation, which is dampening real GDP growth but leaving nominal growth largely unchanged. Although the immediate outlook is for real GDP of less than 2%, real GDP growth is likely to strengthen in 2012 as inflation subsides.

Significantly, earnings estimates have remained firm so far in 2011. The only

Today

A combination of very low interest rates - with consequent demand for yield - tight lending conditions and generally healthy balance sheets has seen a resurgence of leveraged bid activity. Strong stockmarkets over the last couple of years have also facilitated a number of successful flotations, commonly known as Initial Public Offerings (IPOs). This recycling of assets is a bit like eBay but on a much grander scale.

When conventional investors deserted the markets in 2008/2009 I suggested that one should never underestimate the buying power and influence of the private equity industry (as well as sovereign wealth funds - but that's another story). Governments will no doubt find ways to regulate and tax them more closely, but in the meantime (there will no doubt be further headline grabbing stories waiting to surface) they could be a key catalyst in the eventual recovery in general economic activity.

notable exception to this is in the banks sector where consensus 2011 estimates have been revised down by around 20%. Based on estimates, a number of sectors are currently trading on similar cyclically adjusted valuation multiples. With consensus growth forecasts likely to be revised down a little further in the period immediately ahead, defensive sectors may continue to outperform cyclicals in the coming weeks. On less than 10x forecast 2012 earnings and an accompanying dividend yield approaching 4%, the balance of risks to the outlook for equities over the remainder of the next 12 months are, in our view, weighted to the upside.



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Market News

Financials

Royal Bank of Scotland's quarterly loss doubles in the first quarter, fanning concerns among some investors that the ailing bank might take longer to return to profitability. The loss grew to £528 million, in the first three months of this year from £248 million in the same period a year earlier. The loss was partly the result of costs linked to a government insurance program RBS tapped to limit losses from its riskiest assets.

Barclays is set to pay out £1 billion for insurance claims. Similarly to **Lloyds**, Barclays said it would not challenge a court decision requiring the bank to compensate customers who had received incorrect advice when buying some personal protection insurance.

HSBC's profit rises 58% in the first quarter after the quality of its loan portfolio improved. Net income rose to \$4.2 billion, from \$2.6 billion in the period a year earlier, while charges for bad loans fell to \$2.4 billion, from \$3.8 billion. However, profit at its investment banking unit fell. In addition it announced plans to cut jobs and scale back its retail banking operations as part of a strategy to reduce costs by as much as \$3.5 billion in the next few years.

Richard Branson's **Virgin Money** plans to make a bid for 600 **Lloyds** branches as he attempts to establish his company's presence on the High Street.

A regulatory loophole could see **Lloyds** sidestep new capital rules - as European banks with insurance arms could evade new capital requirements being brought in under Basel III. Draft legislation may allow EU banks to count a higher percentage of their capital held by insurance subsidiaries as part of their overall capital requirements.

Man Group has raised \$1.5 billion for a new hedge fund based in Japan. The fund raising was more than triple what the market had expected, and is the firm's largest since the financial crisis. The fund, Nomura Global Trend, created in a partnership with the Japanese investment bank **Nomura**, focuses on investing in futures in currencies, commodities and fixed income.

Market News

Comparative Index performance ▼

Indices	Value as at 31/05/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5989.99	-1.32%	1.53%	15.45%
FTSE All Share	3121.07	-1.08%	1.90%	16.76%
Dow Jones	12569.79	-1.88%	8.57%	24.00%
Euro Stoxx 50 EUR	2861.92	-4.96%	2.47%	9.64%
Nikkei 225	9693.73	-1.58%	-5.23%	-0.77%
FTSE A British Government All Stocks	156.59	0.38%	0.13%	0.95%
Sterling/US\$	1.6448	-1.55%	5.35%	13.14%
Sterling/Euro	1.1425	1.25%	-2.05%	-3.29%

Impax, the specialist investment manager dedicated to the environmental markets sector, announced good interim results. Assets under management increased by 30% and revenues increased 56% in the first half. Ian Simm, Chief Executive, said: "Developments of the past few months, particularly unrest in the Middle East, damage to the Fukushima nuclear reactors and China's adoption of a new Five Year Plan, have significantly strengthened the prospects for investors in environmental markets."

Resources

Shares of the Swiss commodities trader **Glencore International** have had a muted debut after its successful \$10 billion initial public offering, the biggest seen in London this year. Glencore sold 1.14 billion shares at £5.30 apiece and investors include **BlackRock**, **JPMorgan Chase** and the Sovereign wealth fund of Abu Dhabi.

The disputed share swap and oil exploration agreement between **BP** and the Russian state-owned company **Rosneft** has collapsed, leaving some BP investors questioning the company's future strategy and freeing Rosneft to look for a new partner in Russia.

Tullow Oil has acquired **Nuon Exploration and Production**, a Netherlands-based North Sea oil and gas company, for €300 million cash.

Royal Dutch Shell is to spend \$12.6 billion building the world's largest floating structure, in a sign of the energy giant's increasing desperation to exploit fields in the remotest areas.

Vedanta Resources is preparing for a £4.5 billion float of its African subsidiary **Konkola Copper Mines** in London as soon as next month.

Good drugs, bad drugs

Shire buys biotech firm for \$750 million - it was one of the most anticipated initial public stock offerings in a while, at least for the biotechnology industry. But a day before it planned to go public, **Advanced BioHealing** agreed to sell itself to Shire for \$750 million in cash. "They got scooped up right at the altar" said a commentator.

Diageo the spirits giant is in talks to buy the **José Cuervo** brand of tequila from its family owners. If Diageo strikes a deal with the Beckmann family, the longtime owners of Cuervo, it would be the company's most significant acquisition in years.

British American Tobacco has acquired Colombia's second-biggest cigarette maker, Productora Tabacalera de Colombia, for \$452 million; Productora Tabacalera makes Mustang cigarettes, the second most popular brand in the country.

Support Services

AMEC, the oil services company reported that trading was in-line with expectations. Its order book stands at £3.25 billion and the company has made three acquisitions recently for a total of £76 million.

Wolseley, the £5.7 billion materials group, has put three of its British businesses up for sale, including Bathstore, which is expected to raise about £300 million.

Serco, the FTSE 100 services group, has agreed to pay up to £385 million to buy Mumbai-based outsourcing company **Intelenet**.

Xchanging, the troubled back-office services group, has sold its US workers' compensation business as it attempts to rehabilitate itself.

Sage, one of Britain's largest software developers, has launched a review of its struggling healthcare division that is expected to lead to the sale of the business.

Other News

Malcolm Walker, chief executive and founder of **Iceland Foods**, has kicked off his bid to buy a majority stake in the chain; the Resolution Committee of **Landsbanki** wants to sell its 67% stake in the retailer. Effectively this is Iceland selling Iceland!

Rank Group has appealed to investors to reject **Guoco Group's** £585.8 million takeover bid, citing the gaming group's recent record and "a strong position in fundamentally attractive markets."

Minerva, the London property developer, has confirmed details of a £194 million takeover offer by a consortium led by **Delancey**, the investment group run by Jamie Ritblat and Area Property, the private equity firm.

Sources: Oriel Securities, Citywire, BBC News & dealbook.com

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